

EC COMPETITION POLICY IN THE AVIATION SECTOR: STATE OF PLAY AND OUTLOOK

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Joos Stragier¹

Introduction

Air transport has been gradually liberalised in the last decade. Today, European airlines have the freedom to fly between any two Community airports and can freely decide fares, new routes and capacities. Air transport has become an increasingly competitive market. New airlines have emerged to compete with traditional flag carriers and consumers can benefit from an increasing number of attractive promotional airfares.

However, the air transport sector faces major structural weaknesses, which prevent the industry and consumers from fully exploiting the liberalised single market. In particular, the European air transport industry remains hampered by strict airline ownership rules and limited access to infrastructure.

Competition policy can usefully contribute to the creation of a healthy environment for the development of an efficient and competitive air transport industry. Competition enforcement must secure that airlines' responses to the new competitive environment do not undermine the benefits, which liberalised air transport markets can provide to travellers. The Commission's enforcement priorities in the air transport field concern three main areas: alliances, mergers and other forms of co-operation between airlines; hard-core restrictive agreements between airlines and abusive behaviour; and industry-wide horizontal co-operation, in particular in the IATA framework.

Market inefficiencies

Regulatory restrictions

The European air transport market still remains largely divided along national lines with flag carriers strongly focused on their home markets. This fragmentation of the internal market stems partly from the lack of a truly external dimension. Although the provision of air transport services within the EU is now fully liberalised, airlines cannot take the full benefit of such liberalisation, because Member States still keep bilateral air services agreements with third countries that discriminate on grounds of nationality. If an EU airline wishes to serve a destination beyond the EU's borders, it

¹ Head of Transport Unit, DG Competition, EC Commission. All views expressed in this paper are strictly personal to the author.

must prove that it is majority-owned by nationals of the Member State from which it wants to fly.

These restrictions prevent European airlines from setting up international subsidiaries outside their home country. Furthermore, any given EU airline is in effect discouraged from acquiring control of another EU airline in a different Member State, because of the fear of losing traffic rights with third countries. As a consequence, the air transport industry, unlike other industries, can currently not normally pursue integration and scale economies through mergers and acquisitions. In this context airline alliances have come up as a partial and provisional answer to the need for restructuring and consolidation.

The Advocate General of the European Court of Justice has concluded in its Opinion of January 31, 2002, in the "Open Skies" cases concerning air transport between individual EU Member States and the US that these nationality restrictions infringe the Community principle of freedom of establishment. If the Court were to confirm this conclusion in its final ruling, a unique opportunity will be provided to allow EU carriers to fully compete with each other on an EU-wide basis for third country traffic. The elimination of the nationality clauses would also take away a major impediment to restructuring and consolidation in the EU airline industry.

It is probably too early to speculate on the scope and timing of the expected changes. However, the implications for both competition and air transport policy could be quite important.

- First of all, the changes of the regulatory environment could lead to increased competition on extra-Community routes. This is particularly important for those markets which today are subject to very restrictive regimes (e.g. UK-US market under Bermuda II).
- The changes could also have a positive impact on competition within Europe through cross-border investments and multi-hub strategies of major European network carriers. This should result in a more integrated European internal aviation market.
- Further liberalisation of international air transport might necessitate a more co-ordinated and integrated external Community air transport policy. In the Commission's view, the two most important air transport markets in the world, the US and the EU should take the lead in moving beyond the bilateral open skies approach. The momentum for change should therefore be used to revitalise the Transatlantic Common Aviation Area (TCAA) initiative, which should ensure a level playing field for competition between EU and US airlines.
- Finally, in order to ensure fair and effective competition on global air transport markets, it will be necessary for the EU to remove the procedural shortcomings as regards the investigation and enforcement powers which the Commission faces today in dealing with air transport competition cases to and from the EU.

Access to infrastructure

Access to infrastructure, in particular access to airport slots is another essential factor to ensure integration of and competition on the European internal aviation market. Limited access to airport slots is a significant barrier to entry to the market. The

current system where incumbent airlines have "grandfather rights" to slots at congested airports makes it extremely difficult for new entrant airlines to obtain access at hub airports. It is also questionable whether the current system based on historical rights can ensure the most efficient economic use of scarce resources.

The Commission last year presented a proposal for technical amendments to the current Slots Regulation. In parallel, it is commissioning a study to look at how more radical reform might work. Again, it would be premature to speculate on future changes in this area. However, the crisis in the aviation industry following 11 September revealed the inflexibility of the current Regulation. Moreover, the Commission's investigations in several airline alliances and merger cases have highlighted the shortcomings of the current slot regime. In fact, very often concerns about proposed airline mergers and alliances arise because competitors cannot easily enter the market because they cannot get slots at congested airports. Improved access to slots would reduce barriers to entry and make it easier to approve proposed consolidations. The most economically efficient way to allocate slots is likely to be through market mechanisms. However, we would need to ensure that such mechanisms do not simply reinforce the positions of carriers, which have already accumulated large slot portfolios over the years at their home base.

Competition priorities in air transport

An essential role for competition policy is to secure that airlines' responses to the increasing competitive environment do not undermine the benefits, which liberalised air transport markets, can provide to travellers.

The Commission's enforcement activities in the air transport sector will therefore continue to focus on the following main issues:

- the competition assessment of alliances and other forms of co-operation between airlines, including, and perhaps increasingly in the future, airline mergers;
- the fight against hard-core restrictions such as naked market-partitioning and price-fixing agreements;
- the removal of restrictive behaviour by network carriers having the potential effect of foreclosing previously liberalised transport markets;
- the assessment of traditionally accepted industry-wide agreements or practices, in particular in the framework of IATA.

Airline alliances and mergers²

The Commission's approach to airline alliances and mergers, and to other forms of co-operation such as code-shares, is generally positive. Alliances can bring benefits to consumers and the economy as a whole from efficiency triggered cost savings as well as from service improvements resulting from combined networks. However, there is a risk that these benefits are achieved at the expense of reducing or even totally eliminating competition in certain markets. Such problems arise particularly on the

² For a more detailed discussion of the Commission's policy concerning airline alliances and mergers, see my paper presented at the 13th Annual Conference of the European Air Law Association, Zurich, Friday 9 November 2001 (http://europa.eu.int/comm/competition/speeches/index_2001.html).

routes between the hubs of alliance partners, where the partners may have been the only competitors before the alliance. As a matter of principle, no group of consumers can be allowed to suffer from the elimination of competition on a sufficiently large route where they have to travel for the sake of "strengthening" one airline or group of airlines.

The Commission's policy so far has been, while accepting the benefits of certain alliances or mergers, to ensure continued competition on all routes affected by alliances. In practice, the Commission has imposed a fairly standard set of remedies, all of them designed to enable other airlines to enter on the routes dominated by the alliance partners or to reinforce existing competitors. In all cases the most important remedy imposed has been the surrender of airport slots to any new entrant. Other remedies include the reduction or freeze of the frequencies flown by the alliance in favour of the new entrant; pricing constraints; block space agreement offers; frequent-flyer program participation; interlining facilities, and regulatory adjustments.

It will not have escaped your notice that, to date, these remedies have not proved particularly effective in restoring new competition on the markets concerned. For example, on the routes operated by Lufthansa/SAS where these remedies were imposed there are still no other airlines competing with these alliance partners (although the threat of entry might have had some moderating effect on the parties' behaviour).

The Commission has therefore started to adjust its remedy approach towards making actual entry of new competitors more likely. A first step in this process is for the Commission to market test the proposed remedies in order to verify whether they are adequate and sufficient to attract effective new or increased competition able to remove the competition concerns raised by the operation. On this basis, the Commission was satisfied before granting an exemption to the Lufthansa/SAS/bmi British Midland co-operation that there was actual interest from third competitors to enter or expand their services on the problematical Frankfurt-London route in view of the proposed remedies. In the Lufthansa/Austrian Airlines alliance case the Commission goes a step further by proposing that the exemption decision should only be granted to the extent that market entry by a new competitor on certain key routes actually takes place.

A remedy approach focused on the actual market entry is an important step towards achieving effective contestability in air transport markets, which are negatively affected by alliances or mergers. However, difficult problems arise when new actual entrants cannot be found. In general airlines operate their services on the basis of a hub-and-spokes system and they will therefore not normally enter a route where they do not have a hub at one end. Since, as we discussed above, EU flag carriers still operate largely from their home markets, direct competition between EU carriers on routes, which do not connect their national hub or gateway is rather unlikely.

Under the current circumstances, the proliferation of extensive alliances within the EU necessarily creates significant competition problems, which are increasingly difficult to remedy. For the future competition assessment of airline alliances and mergers, it will be crucial to see whether European carriers will adapt and restructure themselves to seize new competition opportunities outside their home markets once

the current inefficiencies and fragmentation of the Community aviation market will have been removed. Other factors, which could receive more weight in the future analysis of alliances and mergers include: competition by regional and low-cost-carriers for point-to-point traffic; competition between airports; and substitution between the transport modes and routings.

Fight against hard-core restrictions of competition

The intensification of competition to the benefit of consumers must not be countered by agreements that have the object to restrict competition by means of price-fixing, output limitation or sharing of markets or customers. The Commission is committed to fight against these practices which are undoubtedly the most destructive.

On 18 July last year, the Commission decided to fine SAS and Maersk Air € 39.375 million and € 13.125 million respectively for operating a secret market-sharing agreement. This agreement led to the monopolisation by SAS of the Copenhagen-Stockholm route to the detriment of over one million passengers who use that route every year, and to the sharing out of other routes to and from Denmark.

SAS and Maersk Air had notified a co-operation agreement, which mainly related to code sharing and to frequent-flyer programmes (FFPs). In the course of the preliminary enquiry, it appeared that, coinciding with the entry into force of the co-operation agreement, Maersk Air had withdrawn from the Copenhagen-Stockholm route where it had until then been competing with SAS. It also appeared that, at the same moment, SAS had stopped flying on the Copenhagen-Venice route and Maersk Air had started operations on this route and, finally, that SAS had withdrawn from the Billund-Frankfurt route, leaving Maersk Air -its previous competitor on the route- as the only carrier.

These entries and withdrawals, which were not notified, formed part of a wider market-sharing agreement that included an overall non-compete clause covering the parties' future operations on the international routes to/from Denmark and on the Danish domestic routes.

The market sharing was discovered as a result of on-site inspections. The inspections were carried out in June 2000, in close co-operation with the national competition authorities in Sweden and in Denmark.

As a result of the decision, competition between SAS and Maersk Air, the two largest airlines operating to/from Denmark, was restored to the benefit of consumers.

Market foreclosure

As it happened in other newly liberalised sectors, there is an ever-present danger that the incumbent flag carriers might use unfair methods to protect their vested interests in their home markets. In particular, it should be avoided that airlines make abuse of the dominant positions they may still have on certain markets to foreclose or distort the development of free competition.

One major area of concern are loyalty schemes. In its Virgin/BA decision the Commission made it clear that loyalty driven travel agency schemes used by a dominant carrier create illegal market entry barriers. The Commission found that BA

used to pay extra commission payments to travel agents in return for their fidelity in selling BA's products. The incentives operated by BA had the effect of discouraging travel agents from selling air transport services of other airlines. For this reason the Commission fined BA and obliged the same to change its travel agency payments into a more competition neutral system. Since most private travellers use travel agents to arrange their air travel, it is essential that travel agents are not tied to any particular airline and that they are interested to offer to travellers the full scale of available competitive services. The Commission is currently reviewing the travel agency schemes of the other flag carriers to ensure that the same principles apply to other EC airlines in equivalent situations.

Similar loyalty effects can also result from frequent flyer programs or corporate discount programs.

A frequent flyer program operated by a dominant carrier at its hub is certainly attractive to customers because its large network at the hub allows in particular business travellers to collect more points and to redeem these points on a wider number of destinations. Since, in addition, the business traveller is usually not paying for the ticket, but is benefiting from the FFP free flight, it will be difficult for a new entrant without a competitive FFP or without a developed network at the hub in question to attract business customers for its flights.

So far, the Commission has been assessing the competitive impact of frequent flyer programs mainly in the context of airline alliances. In fact, in order to limit the restrictive effect of the pooling of the alliance partners' frequent flyer programs, the Commission usually requires that new entrants should be allowed to participate in the frequent flyer program operated by the alliance. However, it might be appropriate to look also to the competitive effects of frequent flyer programs as such. Community law does not a priori prohibit large airlines from taking advantage of their networks and thus exploiting certain size-related advantages when marketing their services. The competition rules would however not allow a dominant supplier to give incentives to its customers to be loyal to it, with the object or effect of restricting customers' freedom to choose freely and thus of impeding market access of competitors. However, a case-by-case careful analysis is necessary to clearly make the distinction between illegal exclusionary behaviour and legitimate competitive behaviour.

Corporate discount deals can rise similar competition concerns. First of all, corporate deals might constitute a barrier to entry on certain individual routes. On certain markets, the presence of a network carrier, which has the possibility to grant corporate discounts across its whole network, makes it indeed difficult for point-to-point carriers or for carriers with less complete networks to enter or stay in the market. The existence of corporate deals is therefore an element to take account of in the assessment of an airline/alliance's position on a specific market. Another concern is that some airlines/alliances might abuse their dominant position through bundling practices, i.e. by tying corporate discounts on one route where it is dominant to market shares targets on other routes where it faces competition.

On some recent occasions the Commission has also been involved in examining various allegations of predatory practices by an incumbent carrier trying to force its rivals out of the market by reducing prices below cost. Admittedly, these practices are

extremely difficult to enforce. However, the Commission is committed to act firmly if sufficient evidence of such behaviour would occur. Since it is a fundamental competition policy objective for the liberalised air transport sector that dynamic and entrepreneurial airlines able to shake up the industry and to bring prices down should not be expelled from the market by abusive pricing behaviour by incumbent carriers.

Industry-wide agreements

In the context of its regular review of the competition regulations, the Commission has recently launched a review of the current block exemption for consultations on passenger tariffs for scheduled airline services. In practice this block exemption allows IATA member airlines to take part in twice-yearly conferences to agree fares for interline journeys. Although the tariff conferences are a restriction of competition in that they involve price fixing between competitors, they have been exempted from the competition rules on the basis that they also secure interlining, which brings both economic and consumer benefits and is valued by passengers.

The Commission does not question the benefits of interlining but has been investigating whether these benefits could be secured by less restrictive means than the tariff conferences. In particular, DG Competition last year launched a consultation to examine whether the benefits of these tariff conferences outweigh their restrictive effects and therefore whether a continued exemption can be justified. We received a large number of responses to the consultation paper, which included apart from -as could be expected- various airlines also responses from Member States, travel agents and consumer groups.

The overwhelming majority of those responding, including the representatives of consumers and travel agencies, argued that the IATA tariff conferences secure an important benefit in the form of passenger interlining, and that this benefit was unlikely to be replicated by any alternative, less restrictive system. Any alternative systems, such as bilateral agreements and an posted price system was felt to be either less comprehensive or too complicated to be implemented at this stage.

It would therefore seem appropriate for the Commission to extend the block exemption for a further limited period of time when its current duration expires in June of this year. While prohibiting tariff conferences would not mean the end of interlining altogether, it would reduce the fare products available for a significant number of consumers and, in the short term at least, could make it harder for small airlines to compete. However, as alliances and consolidation develop it might be argued that in the longer term the need for tariff conferences becomes less obvious. Therefore, the Commission will, even if the block exemption is renewed for a limited time period, continue monitoring the IATA conferences and evaluate, in close co-operation with other authorities, the need of any further renewal in the future. Concrete data on the actual importance of the IATA tariff conferences for interlining would be important in this regard.

The Commission is currently also re-investigating the IATA Passenger Agency Program, which defines the conditions for IATA accreditation of travel agents and for ticket sales by these agents and which was approved by an exemption decision in 1991. The main focus of our current investigation is whether this IATA arrangement

could be deemed to prevent travel agents from competing with each other on an EEA-wide basis, thereby contributing to the artificial partitioning of the internal market.

Conclusion

Although much progress has been made since air transport was first liberalised within the EU in 1992, we still have some way to go before we can truly claim to have a common European aviation market. The completion of the internal air transport market and the removal of all remaining regulatory barriers and market inefficiencies should increase competition both within Europe and on international routes outside Europe. The Commission should remain vigilant in applying the Community competition rules where firms attempt to stifle the pro-competitive effects emanating from internal market integration through anti-competitive behaviour designed to sustain market segmentation or to foreclose the development of new competition. While restructuring can be necessary to achieve efficiency gains and competitiveness, the Commission has to make sure that a high degree of concentration does not foreclose routes and airport slots, thereby re-erecting legally removed barriers.