

**OUTLOOK OF EUROPEAN COMMISSION'S COMPETITION POLICY AND
ENFORCEMENT PRIORITIES IN AIR TRANSPORT**

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Ladies and gentlemen,

I feel very honoured to be your guest today. I cannot but agree with Mr Schulte-Strathaus that competition policy is an essential part of a sound aviation policy. By way of introduction to this afternoon's session, I would like to present the main areas of the Commission's current and future competition policy in aviation. In this respect it is important to note from the outset that DG Competition's role today, but even more in the future, is not limited to the enforcement of the EU competition rules. Competition authorities in general and DG Competition in particular have an important competition advocacy function with respect to sectoral legislation, which impact on the competitive structure of the industry. Finally, I would like to touch upon an important development, which will have a significant impact on competition policy and enforcement in the near future, namely the modernisation of anti-trust procedures.

In the aviation sector, there are three main competition enforcement areas, which deserve, I think, our attention. The first obviously concern mergers, alliances and other type of horizontal co-operation agreements between air carriers. The second area relates to unilateral abusive behaviour, in particular foreclosure practices, such as loyalty incentive schemes for travel agents and predatory behaviour. Finally, certain traditionally accepted industry-wide restrictive practices and agreements, mainly in the context of IATA need to be reviewed.

At last year's EALA Conference in Zürich I presented a detailed paper on the Commission's emerging competition policy in the area of airline alliances and mergers. Since then the Commission has been able to finalise some important

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cases. I refer in particular to the long-standing transatlantic alliances cases Lufthansa/ United Airlines/SAS and KLM/Northwest. In the LH/UA/SAS case the Commission could close its proceedings under Article 85 EC on the basis of a package of commitments made by the parties to address the competition concerns on a number of routes from Frankfurt airport to the US, as well as on the basis of a declaration by the German Government, removing possible regulatory barriers for new entrants on those routes. In the case of KLM/NW no commitments were held necessary. In two instances the Commission worked closely together with the UK Office of Fair Trading in assessing transatlantic alliances. In the case of BA/AA, the Commission and the OFT launched a joint investigation, which was closed following the parties' decision to withdraw their alliance proposal in the light of the conditions imposed by the US Department of Transport. As a result of their close co-operation, both authorities were able to reach a common understanding of the benefits arising from the alliance, the possible competition concerns and the remedies that might have been needed to address these. In another transatlantic alliance between bmi British Midland/United Airlines, the Commission did not launch formal proceedings under Article 85 EC but co-operated actively with the OFT, which adopted a formal exemption decision.

The Commission has also recently taken important decisions concerning a number of intra-European airline alliances and mergers. A landmark case concerns the alliance between Lufthansa and Austrian Airlines, which was cleared by the Commission subject to substantive undertakings from the parties. Given the serious effects of the alliance on competition, in comparison to previous decisions, the Commission imposed some type of new remedies. The Commission also cleared the SAS/Spanair merger. Several other airline alliances are currently under active investigation, including the Skyteam alliance between Air France, Alitalia, Delta, CSA, Korean Air and AerMexico; the bilateral alliance between Air France and Alitalia; the co-operation agreements between BA and Iberia and between BA and SNBA. At the same time we of course notice that other possible co-operation agreements are coming up such as the arrangements between Continental, Northwest and Delta, which might also have an impact on the future shape of network competition in Europe.

These developments show that airline alliances and mergers will continue to play an important role within the ongoing industry restructuring process. It might be expected that in the short run industry evolution will follow largely the same pattern as in the past decade, with a strong preference for increasingly integrated alliances. This situation could of course change significantly in the medium and long term once full-scale mergers between airlines would not any longer be hampered by regulatory restrictions. In fact the Court's recent "Open Skies" decision, in particular its ruling concerning nationality clauses, is an important step towards the removal of the current fragmented regulatory regime for aviation between the EC and third countries. This should in the long run allow the industry to adapt to normal economic restructuring paths, including full-scale mergers and internal growth strategies aiming to set up a European-wide operation basis, thereby making the policy concept of 'Community carrier' economic reality.

From a competition policy perspective, the consolidation process should be triggered by the needs of the individual actors on the market. In principle there should be no preference towards any specific institutional design or airline size, leaving it to the market to find the optimum structure.

Whatever the form or structure of the industry, it is for competition policy to make sure that the liberalised air transport markets remain accessible for existing and new competitors and that passengers can fully benefit from the resulting advantages in terms of wider choice, attractive fares, flexibility and reliable services.

In practice the Commission has accepted that 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, such benefits should not be achieved at the expense of eliminating competition in certain markets. Such problems may arise particularly on the routes where the alliance partners have been the only competitors before the alliance. Where such risk of elimination of competition exists, the Commission usually imposes a set of

remedies that have the effect of making new entry possible as a condition for clearance of the transaction.

Although the assessment of airline alliances has to be done on a case-by-case basis, some general assessment principles have already emerged which illustrate the Commission's current approach.

The first important issue concerns market definition. The Commission applies the so-called "point of origin/point of destination" (O&D) pair approach. This means that 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. On the basis hereof, the Commission examines substitutability between direct and indirect flights and between airports which have significant overlapping catchment areas. Also the possibility to travel with other transport means on the relevant O&D pair must be taken into consideration. The Commission also normally examines the effect of alliances on groups of passengers with have different customer profiles and preferences in terms of schedule flexibility, pricing and journey times (so-called time-sensitive and non-time-sensitive passengers).

Airlines often make the critical remark that the Commission's applied market definition does not take into account that air services are characterised by network competition among airlines and alliances. The Commission has however made clear in the United/US Airways merger case that network competition is still not sufficient to modify the traditional approach on market definition. However, the Commission has implicitly accepted notions of network competition by accepting in the recent transatlantic alliances and merger cases (LH/UA/SAS; KLM/NW and UA/USAirways) that certain indirect routings may be seen as suitable alternatives to non-stop services on long haul routes. The same does not necessarily apply to intra-Community routes. For example, in LH/AuA the Commission did not accept that indirect flights are able to put sufficient competitive constraint on short-haul direct flights. However, in the Spanair/SAS merger the Commission concluded that on medium-haul flights, indirect flights are at a lower disadvantage than on short-

haul services. Network effects are also part of the assessment of the parties' overall market power resulting from the alliance or merger.

In identifying the markets, which might be competitively affected by an alliance or merger, the Commission does not limit itself to routes where the parties have actual overlapping direct flights. Also direct-indirect and indirect-indirect overlapping routes must be considered, in particular on long-haul routes. Moreover, in some cases certain non-overlap routes can be significantly affected by the alliance, in particular in case the non-operating party could be considered as a potential entrant on these routes. The European Night Services judgement has led the Commission to adopt a more economic-based approach towards potential competition in the airline industry by assessing real possibilities of entry. Basically an airline can only be considered as potential competitor on a specific route if that route is either a hub-to-hub route or sufficiently thick to allow entry on a point-to-point basis.

An essential part of the competition test under Article 81 EC Treaty is whether the agreement can contribute to improving the production and distribution of transport services and promote technical and economic progress. Moreover, a fair share of the resulting benefit should be passed on to consumers. It is relatively easy to establish that connecting passengers can enjoy the various types of alliance benefits, such as wider choice of destinations and connections, seamless service and lower fares. The same is less evident for point-to-point passengers on routes where the parties were competitors before. The Commission has therefore been given more importance to this aspect by requiring clear evidence on expected consumer benefits. This was for example the case in the BA/AA investigation where it was found that benefits were focussed on connecting passengers and that the number of these were small relative to the number of local passengers who would have been affected by the loss of competition on transatlantic routes.

Airline alliances often lead to very high market shares (i.e. over 50%). These are however not sufficient to conclude that competition is eliminated on the market or

that the parties have gained market power, which allow them to act to a considerable extent independently of their competitors and customers. A detailed analysis of the competitive conditions on a route-by-route basis is necessary, in particular whether there are entry barriers on the markets concerned and to what extent actual and potential competition provides sufficient constraints on the parties. The Commission usually examines various types of entry barriers such as airport slot shortages, high number of frequencies operated, network effects and regulatory barriers. If high market shares come together with high entry barriers, remedies are most likely necessary in order for the Commission to approve the agreement. For example, in both LH/UA/SAS and UA/USAir the Commission identified significant regulatory and structural entry barriers, which prevented new direct and indirect flights from competing effectively on these markets. After the parties had submitted corresponding undertakings (essentially slot surrenders in Frankfurt airport) and, in the case of LH/UA/SAS, after the German aviation authorities agreed not to apply anymore certain regulatory restrictions with respect to competitive indirect services, the cases could be cleared.

Another good example of the Commission's current remedy approach concerns the LH/AuA alliance. In this case the Commission gave its approval on the basis of a comprehensive set of remedies to enable effective new entry on the most bilateral routes between Germany and Austria. These remedies include common measures such as slot surrenders, FFP participation, interlining facilities and frequency freezes, but also some novel remedies such as a price-reduction mechanism on monopoly routes and the obligation for the parties to enter into special prorate agreements with new entrants and to conclude inter-modal agreements with interested railway companies.

I mentioned earlier that the Commission approved the KLM/Northwest alliance without imposing any remedies. In fact, despite the parties' very high market shares on the relevant transatlantic markets, the Commission did not identify any significant market entry barrier and existing and potential indirect competition was considered to sufficiently constrain the competitive behaviour of the alliance partners.

These elements show that the Commission's competition assessment of airline alliances is clearly moving into the direction of a more economically based approach focussing on real market effects and effective remedies. We are however still facing some important challenges.

First of all, some substantive questions and related assessment criteria need to be further developed or refined in view of new market developments. I refer in particular to questions, which are related to market definition and the establishment of market power. The Commission has for example started looking into the question whether one can identify a market for corporate deals, which should be separated from the traditional O&D markets. Other areas of investigation concern the distinction between time-sensitive passengers and non-time-sensitive passengers (or restricted and non-restricted passengers) and the impact of low-cost carriers on the market for business travel. The Commission has also been undertaking a more in depth assessment based on economic evidence of the question of potential entry on air transport markets. The same applies to the question what minimum restraints and competitive conditions are necessary to prevent an airline from enjoying market power over point-to-point passengers on a route.

Another major challenge we face is the need for a more speedy treatment of alliances. In contrast to the treatment of mergers, investigations under Article 81 EC Treaty are not subject to procedural deadlines. More importantly alliances, which are formally notified, can be implemented pending the Commission's procedure without too many legal risks. The situation might however change fundamentally following the reform of the procedural rules for the application of Articles 81 and 82 EC, which I will touch upon shortly.

Finally, for transport services between the Community and third countries, the Commission continues to be hampered by the current lack of effective and efficient procedural rules for the enforcement of the EC competition rules. Although Article 81 and 82 EC Treaty fully apply to such services in so far as they could affect trade between Member States, the only legal basis for the

Commission to investigate cases involving such services is the transitional provision of Article 85 EC Treaty. The Commission's experience, in particular in the context of its investigation of several transatlantic alliances shows that this system is not satisfactory. In its recent Communication on the consequences of the Court judgements of 5 November 2002 for European air transport policy, the Commission has therefore emphasised that an effective enforcement of the Community competition rules is an essential part of a co-ordinated international EU aviation policy. To that end the EU should have the same effective competition enforcement tools for international aviation as it has for air transport within the EU. In the past the Commission has submitted several proposals, most recently in 1997, to the Council to provide it with such powers. There is now an urgent need to revive such proposals.

Let us now turn to a second major enforcement chapter, namely unilateral market foreclosure practices by incumbent airlines. Whilst liberalisation and increased competition in air transport services over the last decade have brought benefits to consumers, it is necessary to ensure that some of the responses by airlines to this environment do not undermine these benefits. I refer in particular to marketing practices such as travel agency incentive schemes, frequent flyer programs, corporate discount programs and predatory practices. So far the Commission has only built up limited experience in assessing the competitive impact of these practices. In its Virgin/BA decision the Commission made clear that loyalty driven travel agency incentive schemes used by a dominant carrier create illegal market entry barriers and were in breach of Article 82 EC Treaty. Over the last few years the Commission has investigated travel agency incentive schemes of all major EU carriers in order to ensure their compliance with the principles laid down in the Virgin/BA decision. It is expected that most of these proceedings can be successfully terminated in the very near future.

Frequent flyer programs may also have similar exclusionary effects, in particular vis-à-vis new entrant airlines with small route networks. So far the Commission has assessed the competitive impact of FFP's mainly in the context of airline alliances. In particular in cases where these practices were considered to be a

major barrier to entry, it obliged alliance partners to open their FFP's to competitors, which do not operate similar programs. In contrast, the Swedish and Norwegian competition authorities have taken a more direct critical stance against FFP's operated by SAS by imposing a general ban on these FFP's on their domestic markets. Since major flag carriers compete on a global European or international network basis, it might appear necessary in the future to look more systematically and thoroughly into the market effects of these practices in order to develop a common European approach. The same applies to corporate discount deals. In fact the presence of a network carrier which has the capability to grant corporate discounts across its whole network can make it difficult for point-to-point carriers or carriers with smaller networks to enter or stay in the market. More importantly, an airline could abuse its dominant position through bundling practices, for example by tying corporate discounts on routes where it is dominant to market share targets on other routes where it faces competition.

Finally, both the Commission and national competition authorities continue to receive complaints concerning various kinds of predatory practices whereby certain incumbent carriers would try to deter other carriers from entering the market. It should however be noticed that enforcement in this area remains difficult, in particular to distinguish between legitimate competitive responses by incumbent airlines, which can bring new dynamics into the market place, on the one hand, and exclusionary behaviour prohibited under Article 82 EC Treaty, on the other hand.

A further major area of activity concerns industry-wide agreements, in particular in the context of IATA. In June of this year the Commission renewed the current block exemptions for consultations on passenger tariffs, in particular in the context of the IATA tariff conferences, slot allocation and airport scheduling until June 2005. A consultation, which was carried out in 2001, showed that the majority of interested stakeholders still consider the IATA passenger tariff conferences as indispensable to attain the benefits of multilateral interlining. Without the conferences consumers would have a smaller choice of flexible fares and smaller airlines might have fewer interlining opportunities and as a result find it harder to

compete. However, as alliances develop it might be argued that in the longer term the need for tariff conferences becomes less obvious, in particular on dense routes in terms of passenger figures. In order to enable the Commission to facilitate the re-examination whether the block exemption should be further extended after June 2005, the Commission has required participating airlines to collect, for each IATA season, certain data on the relative use of the passenger tariffs set in the conferences and their relative importance for actual interlining.

The Commission has also started to examine other IATA horizontal agreements, recommendations and practices relating to the sale and distribution of air tickets, such as the IATA Passenger Agency Program and related rules. In particular the Commission needs to make sure that these self-regulations do not prevent the development of new distribution forms and practices and that they do not constitute an instrument through which airlines regulate their competitors. In case such agreements would restrict cross-border selling or if they would install discrimination on grounds of nationality or residence, action under Article 81 EC Treaty would become necessary.

A comprehensive and effective competition policy should not limit its field of activity to pure enforcement of the competition rules to individual agreements and practices by market participants. An essential objective of competition policy is also to overcome regulation driven market inefficiencies and therefore to enhance further liberalisation of markets. I already referred to the current unsatisfactory regulatory framework for global aviation and the need for effective competition tools in order to ensure that consumers can reap the benefits from increased competition resulting from full liberalisation of international air traffic. In the next few months we will therefore have to focus our attention on the establishment of a pro-competitive framework for international aviation in response to the Court's "Open Skies" judgement. The future creation of a bilateral common aviation area between the US and European Union or any other bilateral or multilateral aviation framework do not require however ad hoc or sector specific competition rules. The emphasis should rather be on convergence in the application of the competition rules of the relevant constituencies. An essential element hereof will be the

development of effective co-operation and co-ordination rules and practices between the competent competition authorities.

Open and fair access to airport slots is an essential factor for the development of competition and integration of air transport markets. However, under the current slot allocation system, most of the flag network carriers control the vast majority of slots at their respective national hubs on the basis of grandfather rights, making market entry and head-to-head competition with the hub-carrier on many routes very difficult, if not impossible. In the light of the expected increasing restructuring and consolidation of the air industry, fundamental progress on the slot access issue becomes even more crucial to ensure effective competition in the European aviation. The Commission has recently launched a study to develop market oriented slot allocation schemes and to assess their feasibility. From a competition policy viewpoint, it is important that any new framework for market access to slots also includes sufficient safeguards for new entrants.

I would like to conclude by mentioning a major challenge for competition policy and enforcement in the years to come, in particular the project of modernisation of the anti-trust procedural rules. In the next few days the Council is expected to adopt a new basic procedural regulation to replace the current Regulation 17. The essential point of the reform is the removal of the current centralised authorisation system under Article 81 EC Treaty by a system of exception which is directly applicable by the EC Commission, the national competition authorities and courts. The specific procedural rules, which are currently applicable to transport sectors, including aviation, will be removed. It would lead me too far to discuss at this occasion all specificities and consequences of this major reform. I would just like to emphasise that the new enforcement system should allow the Commission to focus on the most serious infringements and on sectors which still require major policy development and substantive guidance. I hope that I have sufficiently demonstrated in my presentation that air transport is to be considered as such. A major task for the Commission in the coming years will therefore be to improve market monitoring and data gathering in order to further develop and define Community competition policy in areas such as alliances, foreclosure practices,

network effects and structural regulatory barriers. Finally, to be successful in these tasks the Commission will have to enhance its close co-operation with Member States' competition authorities. In aviation, the Commission and the national competition authorities have already started building an efficient network through the European Competition Authorities Aviation Working Group, which started its activities in the course of this year.

Thank you very much for your attention.