

**AIRLINE ALLIANCES AND MERGERS -
THE EMERGING COMMISSION POLICY**

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Introduction

Liberalisation and globalisation of air transport has resulted in recent years in a rapid expansion in the number of airline alliances and co-operations between individual airlines or groups of airlines both at a European level and globally. More importantly, these co-operations tend to deepen their scope and depth, moving beyond "naked" code-sharing and joint marketing arrangements into complex alliances extending to all aspects of the airline business and coming close to actual mergers.

In spite of these developments, the airline industry landscape is still very unstable and fragmented, in particular within Europe. Consolidation would be a logical response to the market deregulation of the 1990s. Air carriers in Europe also recognise that they will need to expand beyond their national home markets, through mergers and acquisitions, in order to build up larger networks and gain economies of scale. However, the current system of bilateral agreements for international air services with its nationality restrictions and designation rules and general restrictions as far as foreign ownership of airlines is concerned are clear handicaps for this natural process to take place. In this context airline alliances have come up as a partial and provisional answer to the need for restructuring and consolidation.

Airline alliances raise significant competition issues. Although alliances can enhance efficiency and service quality, they can also significantly reduce or even eliminate competition in certain markets.

The Commission has in the recent years gradually developed and refined its competition analysis of airline alliances and mergers. In particular, the Commission has through the handling of several cases acquired a better understanding of the nature of competition in the airline industry and the special features of this industry which might foster anti-competitive conduct. As a consequence, the Commission further elaborated its policy on the regulatory and competition remedies that are necessary to enhance competition on certain markets that are negatively affected by an alliance or merger.

The Community competition rules (i.e. Articles 81 and 82 EC Treaty) fully apply to air transport both within the EU and between the EU and third countries. However, with respect to third country routes, the Commission has (still) only limited powers under Article 85 EC Treaty to ensure the application of the competition rules.³ The national competition authorities have parallel competences to rule on the admissibility of agreements concerning third country routes pursuant to Article 84 EC Treaty. In order to avoid unnecessary duplication of procedures and investigations and to minimise the risk of legal conflicts, the Commission has in recent transatlantic alliance cases intensified its close co-operation with competent national competition authorities.

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² Head of Transport Unit, DG Competition, EC Commission. All views expressed in this paper are strictly personal to the author.

³ Council Regulation (EEC) N° 3975/87 of 14 December 1987 laying down the procedure for the application of the rules on competition to undertakings in the air transport (OJ L 374, 31.12.1987) only applies to air traffic between Community airports.

In contrast to the application of Articles 81 and 82 EC Treaty the Commission has full and exclusive competence to deal with airline mergers that fall under the EC Merger Regulation, even if they relate to air transport services on third country routes.

Over the last few years the Commission has adopted a number of formal decisions on airline alliances and mergers. Moreover, a number of important cases are currently under active investigation and they are expected to be finalised in the coming months. It becomes clear from looking more closely to these cases that the Commission's policy and practice has evolved over time. This applies in particular to the Commission's assessment of the relevant market, the identification of competition problems and the type of remedies that are required.

Definition of relevant market

Origin & Destination city pairs

The Commission has traditionally defined relevant markets in air transport cases⁴ on the basis of a route or bundle of routes.⁵ In the *KLM/Alitalia* merger decision,⁶ the Commission clarified the market definition in air transport focusing on demand substitutability. In particular, it concluded that each point-of-origin/point-of-destination pair constitutes a relevant market, and that such market includes a route or a bundle of routes comprising:

- The non-stop flights between the two airports;
- Non-stop flights between the airports whose respective catchment areas significantly overlap with the catchment area of the airports concerned;
- Indirect flights between the airports concerned to the extent that these flights are substitutable for the non-stop flight.

To this should be added the possibility to substitute air transport by other transport services such as car, coach, train and/or ferry which is in view of their physical and technical characteristics are functionally interchangeable with air transport at a given price.

The Commission made it also clear in the *United Airlines/US Airways* merger decision which concerned transatlantic traffic, that network competition is still not sufficient to modify the traditional approach on market definition, i.e. that each city-pair as defined above constituted a distinct market. It argued that, from the demand-side, the consumer continues to ask for a transport service between two points. Moreover, despite the evolution of the supply-side, there is no indication that airlines are able to start services between all transatlantic city-pairs and market them in the short term without incurring significant additional costs and risks.⁷ The possible impact of network competition on the definition of the relevant market is even lesser with respect to intra-Community air services.⁸

⁴ In the analysis hereunder, the market for the scheduled air transport of passengers is examined. Chartered air transport does not constitute a genuine alternative to scheduled air transport (e.g. Commission decision of 16 January 1996 in case No IV/35.545 - *Lufthansa/SAS* (OJ L 54, 5.3.1996), para 31.

⁵ e.g. Commission decision of 20.7.1995 in case IV/M.616 - *Swissair/Sabena*, para 19; Commission decision of 28.2.1997 in case IV/M.857 - *British Airways/Air Liberté*, para 15; Commission decision of 3.8.1999 in case IV/M. 1494 - *Marine-Wendel/SairGroup/AOM*; see also Case 66/86 - *Ahmed Saeed Flugreisen* [1989] ECR 803;

⁶ Commission decision of 11.08.1999 in case M/JV-19.

⁷ Commission decision of 12.01.2001 in case COMP/M.2041 - *United Airlines/US Airways*, paras 11-12.

⁸ In *KLM/Alitalia* the Commission did not accept the argument. This approach does not exclude that the Commission takes into account in its competition analysis the existence of networks controlled by the airlines (see hereinafter).

Time-sensitive and non-time-sensitive passengers

The Commission generally makes a further distinction between "time-sensitive" and "non-time-sensitive" passengers in its competition analysis of airline alliances or mergers. The distinction is also recognised by the Court of First Instance.⁹ Time-sensitive passengers - mainly but not exclusively those travelling on business - are mainly interested in reaching their destination in the shortest possible time and they require that the airline offers them the possibility to change their reservation at short notice. Non-time-sensitive passengers - mainly but not exclusively leisure passengers - are prepared to accept longer journey times and are generally more price-sensitive.¹⁰

The time constraint remains an important factor for business passengers to determine their choices of airlines. In general these passengers typically are less willing to substitute for alternative (longer) times or paths than non time-sensitive passengers. However, there is a correlation between the extra time a business traveller is willing to spend by travelling at alternative times or alternative paths (one-stop services or via alternative airports) or by using alternative transport modes and the overall travelling time. Other main factors that influence business passenger choice are schedule, frequency, quality of service and overall travel comfort. Most importantly, time-sensitive passengers generally require flexibility to change routings and flight times and they are therefore ready to pay higher priced unrestricted first, business or economy tickets.

Direct and indirect services

The Commission accepts that relevant O&D city pairs might include indirect flights between the airports concerned, to the extent that these flights are substitutable for non-stop flights. Substitutability of direct routes with indirect routes depends on a number of factors such as the flight time, the frequencies and schedules and the travel conditions. In particular, on short distances (i.e. on most intra-European flights) time-sensitive passengers will not normally replace a direct by an indirect flight as a result of a price increase for direct flights. In line with earlier cases¹¹, the Commission found in *KLM/Alitalia* that on the two city pairs where competition concerns rose (i.e. Amsterdam-Milan and Amsterdam-Rome) indirect routes are not reasonably substitutable to direct routes where these exist.¹²

The situation might however be different on long-haul routes. In *United Airlines/US Airways* the Commission accepted that, on long-haul flights such as transatlantic services, indirect flights are at a lower disadvantage than on short or medium-haul services, because intermediate stops have a lower relative impact on total elapsed time as the total trip duration increases. In such cases, factors other than total flight duration are more important for choosing a given flight, such as convenience of schedules, number of frequencies and

⁹ Judgment of the Court of First Instance of 15.09.1998, Joined cases T-374/94, T-375/94, T-384/94 and T-388/94, *European Night Services Ltd and others v Commission* [1998] ECR II-3141.

¹⁰ e.g. Commission decision of 9.12.1998 in case IV/M.1305 - *Eurostar* (paras 14-16); *United Airlines/US Airways*, para 18; *KLM/Alitalia*, para 21.

¹¹ In *British Airways/Dan Air* (Commission decision of 17.02.1993 – case IV/M.278) the Commission concluded that the short distance between Brussels and London and the number of frequencies available show that it is quite unlikely that a passenger would consider doing a journey through some intermediate point. The question of airport substitution between Heathrow and Gatwick was left open. In *Swissair/Sabena* the Commission considered that it is unlikely that a passenger would consider doing the journey through an intermediate point, in view of the short distance between Brussels and each of the four Swiss destinations, as well as the sufficient number of frequencies available on each route. In *British Airways/TAT* (Commission decision of 27.11.1992 in case IV/M.259) the Commission concluded that the short distance between Paris and London and the number of frequencies available show that it is quite unlikely that a passenger would consider doing the journey through some intermediate point.

¹² The Commission did however accept that, as regards non-time sensitive passengers, indirect flights may constitute valid alternatives to direct flights on other intra-European O&D pairs such as the Danish-Italian and the Iberian peninsula-Amsterdam O&D markets (see paras 41-43).

flexibility, frequent flyer programmes and corporate schemes, type and quality of service, etc. On the relevant transatlantic city-pairs in this case, indirect services accounted for at least 20% (and up to 50%) of the point-to-point passengers concerned. The Commission concluded that certain indirect flights appear to effectively compete with non-stop services, in particular these indirect flights which are marketed as connecting flights on the city-pair concerned, and which only cause a limited extension of the trip duration.¹³

Airport substitution

The question whether flights from two or more airports actually belong to the same relevant market first depends on the number of passengers living in the overlap between the catchment areas of the airports concerned. If the proportion of passengers living in the overlap area is significant, airlines at each of the airports concerned will normally compete for those passengers and will determine their offer (prices) accordingly. The competitive conditions for flights from each of those airports will therefore be competitively constrained by those at the other airports concerned, so that flights from all of the airports considered actually belong to the same relevant markets.¹⁴

Airport substitutability will also depend on the nature of the services offered from the different airports. In particular for time-sensitive business travellers, the choice of airport will also be determined by the number of frequencies,¹⁵ schedule, connectivity and overall quality of airport service.

In *British Airways/Air Liberté*, the Commission did not accept substitution between Toulouse Blagnac and Bordeaux Mérignac.¹⁶

In *KLM/Alitalia* the Commission concluded that the catchment areas of the airports of Brussels, Düsseldorf and Amsterdam do not significantly overlap as far as short haul flights between Amsterdam and Milan and Amsterdam and Rome are concerned. In general, the Commission observed that the size of an airport catchment area varies according to the flight time of the flights concerned.¹⁷

In *Lufthansa/SAS/bmi British Midland*¹⁸ the Commission found that in the case of non-time-sensitive passengers travelling between London and Frankfurt, the five London airports on the one hand, and Frankfurt main airport and Frankfurt-Hahn on the other hand, can be considered to be substitutable. In contrast, substitution between Frankfurt and other regional airports was considered to be marginal, in view of the short travelling time between London and Frankfurt. In the case of time-sensitive customers travelling between London and

¹³ Concretely, in the current case, the Commission found that for indirect services to be competitive they should have an in-flight duration comparable with that of the non-stop service, and their connection time should be no longer than 150 minutes.

¹⁴ *United Airlines/US Airways*, para 20.

¹⁵ In *Eurostar* the Commission concluded that the relevant market for time-sensitive passengers appears to be limited, on the air side, to Heathrow and Gatwick. The Commission referred to the importance of Heathrow, in particular as a major international 'hub' airport, and to the much greater frequency of services it offers on the routes in question (i.e. London-Brussels/Paris) by comparison with the other London airports.

¹⁶ The Commission did not determine whether flights from Orly and Roissy have to be considered as different markets, since the operation did not raise any doubts even on the basis of the narrowest market definition.

¹⁷ *KLM/Alitalia*, footnote 6: in particular, a passenger will accept to travel (for example, by car) a longer distance to the departure airport to catch a long haul flight than to catch a short haul flight, because of the minor impact of that additional travel by car on the total travel time.

¹⁸ The Commission decided not to raise serious doubts pursuant to Article 5 of Council Regulation (EEC) No 3975/87 to a Tripartite Joint Venture Agreement between Lufthansa, SAS and British Midland to co-ordinate their scheduled passenger air transport services within the EEA to and from London Heathrow Airport and Manchester International Airport. See Commission Press Release IP/01/831 of 13.06.2001 and Notice in OJ C 83 of 14.03.2001.

Frankfurt, the Commission did not regard a service between Stansted and Frankfurt-Hahn as belonging to the same market.¹⁹

In *United Airlines/US Airways* the Commission did not accept the parties' argument that the transatlantic flights in question from Frankfurt and Munich are competitively constrained by flights from certain German regional airports or other European hubs. In fact, the Commission did not accept that there are large overlaps between the catchment areas of the Frankfurt or Munich airport on the one hand, and the catchment areas of Amsterdam, Brussels and Zurich. The Commission also found that only a small number of passengers in the Frankfurt area currently take surface transport to Amsterdam, Brussels or Zurich to take a flight for most of the transatlantic destinations considered. Moreover, the services offered at the non-German hubs are longer, not more frequent and more expensive. It was further concluded that German regional airports, while theoretically in a better position to compete with Frankfurt or Munich, do not offer suitable alternatives to Frankfurt or Munich, at least for the transatlantic destinations where non-stop services are operated from Frankfurt or Munich. Those regional airports offer less frequencies, connections and destinations than Frankfurt or Munich and their flights are longer.

Substitution between different transport services

In *British Midland v. Aer Lingus* the Commission considered that on the route between Dublin and London, the characteristics of surface transport (speed, convenience, several changes of transport means) are sufficiently different to preclude substitutability of demand by most (air) travellers. In other words, there is considerable specific demand for fast, flexible and convenient travel between the two cities, which can only be met by air transport.

In *British Airways/Air Liberté* the Commission considered that although there are several forms of transport available between Paris and Toulouse for a consumer, in particular scheduled air transport or rail transport, these alternative modes of transport are still too different for concluding to a sufficient substitutability, because of factors such as the longer duration of the rail journey and the lower number of direct and speed frequencies on the rail way Paris-Toulouse.²⁰

However, in *British Airways/TAT (II)*²¹ the Commission concluded that on the London-Paris routes Eurostar is expected to exert considerable competitive pressure on the airlines operating on these routes, at least in respect of point-to-point traffic. Also in *Lufthansa/SAS* the Commission considered that theoretically, high-speed trains offer an alternative to air transport, in particular over medium distances.

¹⁹ In *British Midland v. Aer Lingus* (Commission decision of 26.02.1992 in case IV/33.544 - OJ L 96, 10.04.1992, p. 34) the Commission defined a separate market for air travel between Dublin and London Heathrow. It found that in particular business travellers traditionally prefer Heathrow because other London airports are not served as frequently as Heathrow, and because they do not offer a similar range of connections and therefore will be less suited to onward travel beyond London. In *British Airways/TAT*, the Commission accepted that a certain degree of substitutability exists between Heathrow and Gatwick for services between London and Paris and between London and Lyon, in particular for passengers whose final destination is London. In *KLM/Air UK* (Commission decision of 22.9.1997 in case IV/M.967) the Commission indicated that there might be a certain degree of substitutability between the different airports of the London area but left the question open in its final decision.

²⁰ Also in *Swissair/Sabena*, the Commission concluded that there is only a limited degree of substitutability between scheduled air travel and other forms of transport, such as rail transport, on the routes between Belgium and Switzerland, in view of a number of factors, such as price differences and longer duration of the journey.

²¹ Commission decision of 26.08.1996 in case No IV/M.806.

Effect of airline mergers and alliances on competition

Airline alliances often involve co-operation on all aspects of the airline business, including co-ordination of fares, seating capacity, schedules and marketing and they can therefore come close to actual mergers.

Airline alliances or mergers may lead to cost efficiencies through the rationalisation of the network and economies of scope. Passengers may also benefit from such transactions through an enhanced offer of seamless travel and better services.

However, alliances and mergers can reduce significantly or eliminate competition in those markets which were previously served (or could have been served) by both the merger or alliance partners. In assessing the anti-competitive effects of an airline merger or alliance, the Commission therefore examines the extent of overlap between the respective networks of the airlines. It furthermore examines whether third airlines face significant barriers to entry or expansion on these markets. In particular, the Commission considers structural conditions prevailing at airports and their capacity both in connection with the routes and separately.²² Finally, the impact of an extensive or high volume network in a given geographical area has to be examined.²³

Overlapping services

The extent and scope of overlap of networks can differ. The following categories of overlapping services can be distinguished: (1) overlap between the parties' direct services; (2) overlapping services where only one party operates direct flights; (3) overlap between indirect services only.

In considering overlapping services, the Commission takes account of both actual and potential competition between the alliance or merger partners. However, in accordance with the ruling of the Court of First Instance in *European Night Services*²⁴, an economically realistic approach is necessary for the assessment of potential competition. In fact, major airlines have transformed their route structure from a "point-to-point" network to a "hub-and-spoke" network. Such airlines will realistically only consider entry on any given O&D city pair if the service is operated from their own hub and if the service can generate sufficient (point-to-point and connecting) traffic to allow operation at a minimum efficient scale.

To the extent that alliances or mergers concern air transport markets in the Community, the Commission has been focusing its analysis on the direct overlap of the parties' services between their respective national hubs or countries.

For example, in *Lufthansa/SAS* the Commission found that the parties' co-operation restricted competition on several routes between Scandinavia and Germany operated by one or both of the parties.

In *KLM/Alitalia* the Commission focused on the O&D pairs where both parties operate with direct flights. It concluded that the joint venture would have created a single dominant position on the Amsterdam-Milan and Amsterdam-Rome O&D city-pairs, since KLM and Alitalia were the only operators on these routes before the concentration. The same did not apply to the London-Milan and London-Rome pairs²⁵, despite the fact that the parties held

²² e.g. *Swissair/Sabena*, para 18.

²³ e.g. *British Airways/TAT*, para 19.

²⁴ Judgment of the Court of First Instance of 15.09.1998, [1998] ECR II-3141, para 137.

²⁵ On London-Rome and London-Milan, Alitalia itself operates direct services, while KLM operates through its subsidiary KLM-UK.

significant market shares on these markets, given the presence of other carriers, in particular British Airways as a hub operator in London. In addition, the Commission considered other Italy-Netherlands O&D pairs served by a direct flight by one of the parties, in particular KLM. However, Alitalia was not regarded as a potential competitor on these markets due to the design of its network and the thinness of these routes.

In *Lufthansa/SAS/bmi British Midland* the Commission was mainly concerned about British Midland's withdrawal from the London-Frankfurt market where it was an actual direct competitor of Lufthansa.

In cases involving long-haul traffic, in particular transatlantic services, not only direct overlaps should be considered but also overlaps between direct and indirect services and between both parties' indirect services may be relevant.

In *United/US Airways* the Commission therefore reviewed all possible overlaps. The merger would first have led to the combination of the two only non-stop service providers between Frankfurt and Philadelphia.²⁶ The operation would further have created overlaps on other routes where one of the parties is active on non-stop services, while the other party provides competitive indirect services.²⁷ In such cases, competition concerns are more likely to arise on routes connecting the airlines' hubs. In the present case, the Commission identified three problematic routes, ea. Frankfurt/Charlotte, Philadelphia/Munich and Pittsburgh/Frankfurt, which connect a US Air hub with a Lufthansa hub or gateway. On each of these routes, US Air offers a non-stop service and carries more than 70% of the O&D traffic while United and Lufthansa offer indirect services which account for 24-54% of the remaining passengers. The Commission concluded that the loss of this indirect competition would significantly strengthen the competitive position of the non-stop carrier. In contrast, on other routes not connecting the parties' respective hubs, the Commission found that the party offering indirect services is only a marginal player and would therefore not materially affect the non-stop services operated by the other merger partner. Finally, the Commission also examined overlap routes where both the parties only operate indirect services. Despite high market shares on some of these routes (between 40-60%) the Commission concluded that the merged entity would continue to face sufficient competitive constraint from alternative routings. In this context, the Commission took account of the (relatively) small size of the markets and the available excess capacity of third carriers for these routes.

Competition by third competitors

An alliance or merger can result in a high combined market share on certain routes. However, this is not sufficient to conclude that the alliance or merger will eliminate competition or lead to dominance on those markets. It is also necessary to examine to what extent other carriers can enter or expand their services and therefore constrain the market behaviour of the merger entity or alliance. In this respect, the Commission has identified a number of factors, which might restrict or prevent competition by third carriers on some markets.

First, any carrier without a hub or a substantial gateway at one of the endpoints of the city pair might face great difficulty to provide new effective non-stop services in hub-to-hub markets. In particular, where the number of O&D passengers is limited, successful entry requires that the non-stop flights carry also a sufficient number of connecting passengers. This requires that the competing airline operate from a hub or important gateway.²⁸ The situation might however be different if there is sufficient O&D traffic to support point-to-point services.

²⁶ This route connects US Air's hub at Philadelphia with Lufthansa's hub at Frankfurt. US Air and Lufthansa (under codeshare with United) are the only two non-stop services on this route.

²⁷ In this case, the Commission considered a minimum increment of 3%.

²⁸ See *United Airlines/US Airways*, para 42.

The high number of frequencies, which the alliance partners can offer together is another factor which could weaken the position of third competitors. This will increase the attractiveness of the parties' services, in particular by increasing flexibility for time-sensitive passengers.²⁹

Other barriers to entry or expansion are the provision of enhanced frequent flyer programmes and corporate deals.³⁰

A specific barrier concerns the regulatory situation governing the provision of certain international air services. For example, in *Swissair/Sabena*, it was concluded that the mono-designation rule³¹ in the bilateral air transport agreement between Switzerland and Belgium prevents effective new entry into the routes between Belgium and Switzerland. Also in the *Lufthansa/SAS/United Airlines* and *British Airways/American Airlines* transatlantic alliance cases the Commission considered that regulatory barriers limited the scope for competition on the relevant markets by third carriers.³²

Airports

The most significant constraint for third competitors on many markets is the availability of take-off and landing slots at the airports concerned. Availability of slots is an essential condition for the creation of a stable regular service and thus effective new entry into the markets. Moreover, slots should be available at some peak hours in order to provide appropriate services to time-sensitive passengers.

In several cases the Commission concluded that there is effectively a problem of access to slots at some highly congested airports where relevant slots are scarce.³³

In *Lufthansa/SAS/bmi British Midland* the Commission considered that on the London-Frankfurt market the joint venture has overall a much better position with regard to slots at both ends of the market. In fact, taking into account British Midland's slots at Heathrow, together with Lufthansa's control of slots at Frankfurt, the parties can more easily adapt their schedules to market developments and increase frequencies on the route. In contrast, given the scarcity of slots at Frankfurt airport, Lufthansa's main competitor on this route, British Airways, is clearly hampered to expand services in the same way.

In *Swissair/Sabena* the Commission indicated that slot availability must be viewed not only in connection with specific routes, but also separately, as an essential facility to operate from a given airport. However, in the case in question, the parties' combined slot portfolio as such was not considered to raise concerns.³⁴

²⁹ *United Airlines/US Airways*, para 44. In *KLM/Alitalia* the Commission noted that the parties operate a relatively high number of frequencies compared to the thinness of the markets. The relatively low average load factor on the routes was another factor, which makes the routes less attractive for a new entrant.

³⁰ e.g. *LH/SAS*, para 53.

³¹ The rule means that each Government at the end of the route is allowed to designate only one carrier owned and controlled by its own nationals. The only airlines, which were designated to fly on the routes between Switzerland and Belgium, were Swissair and Sabena.

³² This concerns in particular Community carriers other than those owned or controlled by nationals of Germany, Denmark, Sweden, Norway or the UK which are restricted to operate direct and indirect services on the routes between the above countries and the US and to set their fares freely (see Commission Notices, OJ C 239, 30.7.98).

³³ e.g. *Swissair/Sabena*; *LH/SAS*; *KLM/Alitalia*; *United Airlines/US Airways*; *Lufthansa/SAS/bmi British Midland*.

³⁴ This is so far the only case where the Commission indicated that slot availability should also be viewed separately from specific routes.

Network effects

In several cases the Commission has indicated that competition in the air transport sector also takes place between networks and that therefore the impact of the parties' combined network in a given geographical area should also be analysed.³⁵ In general, the alliance or merger can have the effect of enhancing the demand for the network, which can increase the market power of the network.

In the cases decided so far, network effects as such did not raise significant competition concerns.³⁶ However, in some cases, the fact that the merger or alliance partners participate to different alliances was considered problematical. For example, in *Swissair/Sabena* the Commission considered that Swissair's participation in the European Quality Alliance - together with Austrian Airlines and SAS, which has also entered into a co-operation agreement with Lufthansa- leads to an extensive integrated European network, which carries in Europe more than twice as many passengers as the next largest carrier.³⁷

The Commission has however also accepted that certain airline alliances may enhance network competition. In *Lufthansa/SAS/bmi British Midland* it was concluded that British Midland's joining of the Star alliance will foster competition between this alliance and the Oneworld alliance with British Airways.

Remedies

Where the above analysis lead to the conclusion that the alliance or merger risks to eliminate competition or to create a dominant position in certain markets, the alliance or merger could normally not be accepted under the competition rules without effective measures to remedy the competition concerns.³⁸

In view of the fact that the airline resources for the operation on a certain route cannot be considered in isolation with the rest of the company, requiring the divestiture of the parties' activities on a given route may have no economic or industrial relevance.³⁹ In previous cases the Commission has therefore accepted remedies, which are designed to encourage the entry of new competitors or the development of existing competitors.⁴⁰

In earlier cases the Commission did not require the parties to actually seek a new entrant or incumbent competitor willing to commence or increase services on the problematical route(s), but to facilitate such new or additional competition, in particular to offer airport landing and take-off slots should an entrant materialise. However, experience indicates that such approach might fail to sufficiently address the competition concerns. For example, in *Swissair/Sabena* and *Lufthansa/SAS* no competitor has entered the markets on which remedies were imposed

³⁵ e.g. *Swissair/Sabena*; *British Airways/Air Liberté*; *KLM/Alitalia*.

³⁶ e.g. *KLM/Alitalia*, paras 45-46; *United Airlines/US Airways*, paras 71-73.

³⁷ See also *Lufthansa/SAS*.

³⁸ Article 81 EC Treaty (in particular Article 81 §3 referring to the elimination of competition) or EC Merger Regulation which does not allow the creation or strengthening of a dominant position.

³⁹ See *KLM/Alitalia*, para 68.

⁴⁰ See Commission Notice on remedies acceptable under Council Regulation (EEC) No 4064/89 and under Commission Regulation (EC) No 447/98, OJ C 68 of 2.3.2001, para 13: "Where a proposed merger threatens to create or strengthen a dominant position which would impede effective competition, the most effective way to restore effective competition, apart from prohibition, is to create the conditions for the emergence of a new competitive entity or for the strengthening of existing competitors via divestiture". Note that in *Lufthansa/SAS* the Commission considered that only routes with a capacity exceeding 30,000 seats per year should be considered.

(although the threat of entry might have had some moderating effect on the parties' behaviour).⁴¹

In some recent cases the Commission therefore started to systematically do a market test prior to accepting 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.⁴² 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 relevant route in view of the proposed remedies. Another example concerns the co-operation agreement between *Lufthansa* and *Austrian Airlines* where the Commission together with the parties has been examining actively possibilities of actual market entry by other carriers on routes between Austria and Germany.⁴³

While the divestment of slots at congested airports has been at the core of the remedies in all cases, the Commission has also considered other types of remedy. Moreover, its policy on remedies is still evolving and it can vary depending on the characteristics of the markets in question.

Slot remedies

Council Regulation (EEC) No 95/93⁴⁴ lays down the rules and procedures for the allocation of slots at Community airports. The slot surrenders, which are agreed upon by the parties or imposed by the Commission as a condition for granting an exemption, constitute an *ad hoc* mechanism of slot allocation, which serves the purpose of addressing specific competition concerns on certain markets.⁴⁵ It is therefore necessary in each case to specify the conditions and mechanisms for the transmission of slots to competitors.

- In order to ensure that slots are given to carriers that offer the most effective competition, in some recent decisions, the Commission has required specifications for the selection of eligible recipients of slots.

For example, in *United/US Airways*, slots were to be made available to carriers, which are able to provide a competitive air service on the relevant routes. Such competing service was defined as a non-stop or indirect scheduled passenger air service operated on a daily basis, 7 (or in any case not less than 6) times a week on one or more of the relevant city-pairs and, in the case of an indirect flight with a connecting time of not more than 150 minutes.

In *Lufthansa/SAS/bmi British Midland* preference was to be given to an airline not currently operating on the Frankfurt-London route. If the new entrant did not want all the slots, then they had to be made available to incumbents on that route for additional frequencies. It was further specified that preference was to be given to airlines operating between Frankfurt and London Heathrow/London Gatwick/City airports in order to address specific competition concerns with regard to point-to-point time-sensitive customers.

⁴¹ In *KLM/Alitalia*, the Commission considered that the merged entity will not be able "to behave independently of the competitive constraints imposed by the *effective threat of entry* (emphasis added) arising from the conditions created by the undertakings".

⁴² For example, market tests were conducted in *KLM/Alitalia* and *United/US Airways*.

⁴³ See Commission Press Release IP/01/696 of 15.05.2001. The Commission has recently published a Notice setting out the results of its investigation: Commission Notice, OJ C 356 of 14.12.2001.

⁴⁴ OJ No L 14, 22.1.1993, p. 1.

⁴⁵ The above Council regulation provides in its preambles that "the application of the provisions of this Regulation shall be without prejudice to the competition rules of the Treaty, in particular Articles 85 and 86".

- The number of slots to be made available is normally set on the basis of a certain number of new daily/weekly round trips to be operated by new or existing competitors on a given route.⁴⁶

In *United Airlines/US Airways* the Commission considered that one new daily frequency in each of the relevant city pairs (i.e. Frankfurt-Philadelphia, Frankfurt-Charlotte, Frankfurt-Pittsburgh and Munich-Philadelphia) appears adequate for such long haul routes with a limited amount of O&D traffic.

In *Lufthansa/SAS/bmi British Midland* the parties agreed to surrender the six slots that British Midland used for its daily services between Frankfurt and London Heathrow prior to the JV agreement with Lufthansa as well as two additional slots to be chosen by the parties. However, in the event that no new entrants would want slots from the parties, then the parties are obliged to only give up 6 slots to incumbent carriers.

In *Austrian Airlines/Lufthansa*, the parties agree to make slots available to a new entrant for any particular Austria-Germany city pair up to a maximum of 40% of the slots the parties operated on the city pair in question at the time of the notification of their co-operation agreement.⁴⁷

- The slot undertakings usually include further specifications on timing⁴⁸, turn-around times⁴⁹ and slots at peak times⁵⁰.

- The slot provisions normally provide that the carriers concerned should make all reasonable efforts to obtain slots for their services through the normal workings of the slot allocation procedures. The obligation to surrender slots only applies if competitors have failed to obtain the slots within a certain time period of the requested times.⁵¹

In *United Airlines/US Airways* the parties' undertakings included a continuing obligation for the recipient of slots to make all reasonable efforts to obtain the necessary slots at Frankfurt (or Munich) through the normal workings of the slot allocation procedures. If a new (equivalent) slot could be obtained through such procedures, the slot made available by United had to be returned to United.

In *Austrian Airlines/Lufthansa*, it is proposed that any slots obtained by new entrants through the regular slot allocation procedure shall count towards the total number of slots new entrants are entitled to demand. However, this rule would not apply if the parties' share of the total frequencies on the city pair concerned exceeds 60%.

⁴⁶ e.g. *British Airways/TAT* (up to six round trips in any day); *Swissair/Sabena* (up to aggregate number of frequencies operated by the merger parties); in *LH/SAS*, the Commission fixed the same maximum number of slots (ea. 8 slots per day) to be made available at each of the airports concerned for use on any of the problematical routes. In *KLM/Alitalia*, the parties had to surrender a maximum number of slots per day at each of the airports concerned to enable new entrants to operate up to 4 return flights on each of routes concerned. Moreover, the parties were obliged to make available an additional number of slots to allow airlines based in third airports to operate from their hub to one of the three airports concerned with a stopover in one of the other two airports.

⁴⁷ Notice pursuant to Article 16(3) of Council Regulation (EEC) No 3975/87 (OJ C 365 of 14.12.2001).

⁴⁸ e.g. *LH/SAS*, *Swissair/Sabena* (slots will be made available within 60 minutes of the time requested by the new entrant); *KLM/Alitalia* (within 45 minutes); as indicated above, in *Lufthansa/SAS/bmi British Midland*, the parties were obliged to divest the same slots that British Midland had previously used on the same route. The additional two slots were to be freely chosen by the parties, but within 45 minutes of the time requested by the new entrant.

⁴⁹ e.g. *British Airways/TAT* and *Swissair/Sabena* (90 minutes); in *KLM/Alitalia* the parties undertook to provide slots so as to allow a new entrant to turn around its aircraft within 60 minutes. The Commission noted that limited turn around is particularly important for low cost carriers, which must turn around aircraft quickly to reduce costs.

⁵⁰ e.g. *LH/SAS*; in *KLM/Alitalia*, new entrants were to be able to operate two return flights a day on each city pair at peak times.

⁵¹ e.g. *British Airways/TAT*; *Swissair/Sabena*; *LH/SAS*; *KLM/Alitalia*; *Lufthansa/SAS/bmi British Midland*; *United/US Airways*.

- Any slots made available as a competition remedy are offered without any compensation.⁵²

- Furthermore, to the extent that slot divestment is necessary to rectify route specific concerns, the slots, which are made available, can usually only be used for the purpose of operating on the route(s) in respect of which they were made available.⁵³ This obligation is normally imposed upon the recipients of the slots for a limited period of time (i.e. for four consecutive IATA seasons)⁵⁴ or for the lifetime of the exemption decision.⁵⁵

If the recipient of the slots ceases to operate the new or additional service(s) on the relevant route(s) or in case of under-utilisation⁵⁶, it must normally return the slots to the parties. The remedies in *Lufthansa/SAS/bmi British Midland* provide explicitly that, in such case, the parties should make available the returned slots for other new entrants or incumbents. However, if no other new entrant or incumbent would request the released slots within a certain time period, the parties cannot keep these slots for themselves but they have to return them to the Frankfurt slot pool. The same obligation to return slots to the slot pool applies in the event that the slots would not be taken up at all by new entrants or incumbents within the initial period for requesting slots.

- The duration of the parties' obligation to give up slots has varied from case to case. In some decisions, the obligation applies for a relatively long fixed period⁵⁷ or for the duration of the exemption.⁵⁸

In *KLM/Alitalia* the Commission considered that the undertakings had to remain in force on each of the two markets concerned until at least one new entrant is well established on each of these markets. Concretely the parties' undertakings' remain valid until the new entrants have operated on the relevant markets with a certain number of frequencies (i.e. 13 weekly frequencies) for at least four consecutive IATA seasons.

The same principle was applied in *United Airlines/US Airways* where it has been stipulated that the parties' obligation to make available slots is revived until the new service provider has operated a new or additional competitive service for four consecutive IATA seasons.

⁵² e.g. *KLM/Alitalia*; *Lufthansa/SAS/bmi British Midland*.

⁵³ In order to monitor that obligation, the Commission usually relies on private monitoring mechanisms to be established between the parties and the recipients of the slots (e.g. *LH/SAS*; *Lufthansa/SAS/bmi British Midland*; *Austrian Airlines/Lufthansa*). It should be noted that in the Commission provisional position concerning the proposed *BA/AA* transatlantic alliance in 1996, a certain number of slots were to be given up for use only on certain specified routes and another amount of slots were to be made available for use on any route on the overall UK-US market (Commission Notice, OJ C 239, 30.7.1989).

⁵⁴ In particular in the merger cases, e.g. *Swissair/Sabena*; *KLM/Alitalia* and *United Airlines/US Airways*.

⁵⁵ e.g. *LH/SAS*; *Lufthansa/SAS/bmi British Midland*; see also proposed remedies in *Austrian Airlines/Lufthansa*.

⁵⁶ i.e. if new entrant does not make at least 80% use of the slots.

⁵⁷ For example, in *Swissair/Sabena* the obligation expired 5 years after the date of the decision. The same was applied in *British Airways/TAT*. In *LH/SAS* the duration was 7 years.

⁵⁸ e.g. *Lufthansa/SAS/bmi British Midland*; proposed remedies in *Austrian Airlines/Lufthansa*.

- The Commission normally accepts that the parties select the carriers to which the slots will be allocated under the conditions specified in the undertakings.⁵⁹

However, while the Commission's role in the selection process has been rather limited in earlier cases⁶⁰, in *United Airlines/US Airways* the Commission's role is to approve the new entrant(s) to ensure that the new entrant is unconnected to and independent of the parties and that it is a viable existing or potential competitor with the ability, resources and commitment to operate competitive services in the long term.

For the first time also in *United Airlines/US Airways* a trustee was to be appointed to monitor the parties' behaviour, advise the Commission on the suitability of new entrants and to select new entrants in case the parties have not submitted a prospective new entrant for approval by the Commission within a certain time period.

- Finally, the parties to the alliance might be requested to give up airport facilities needed for the effective use of the slots given up.⁶¹

Frequencies

The Commission has been particularly concerned about the possibility for the merger or alliance partners to schedule flights and increase frequencies for the sole purpose of obstructing new entries or squeezing the new entrant from the market. In several cases, the Commission therefore obtained undertakings, which provide for freezes⁶² or only limited increases⁶³ of existing frequencies for a certain period of time.⁶⁴

In the recent *Austrian Airlines/Lufthansa* case, the parties have proposed a commitment which would restrict them, in case of new entry, from adding any frequencies on a particular new entrant city pair for a minimum of four consecutive IATA tariff seasons.

In *KLM/Alitalia* the Commission introduced for the first time the obligation for the parties to reduce their frequencies when a new entrant starts operating on the route.⁶⁵ The reduction had to be equivalent to the number of frequencies operated by the new entrant up to a maximum of 40% of the frequencies actually operated by the parties.⁶⁶ The Commission indicated that the frequency reduction provides new entrants with access to a certain amount of business. It further overcomes the barrier raised by the thinness of the routes in question in relation to the capacity offered on these routes.⁶⁷

⁵⁹ In a number of cases (e.g. *KLM/Alitalia*; *Swissair/Sabena and British Airways/TAT*) it is provided that in case the parties cannot reach an agreement with prospective new entrants, an independent arbitrator shall be appointed to resolve the conflict.

⁶⁰ For example, in *Lufthansa/SAS*, the parties only have the obligation to inform the Commission on the transfer of slots to new entrants.

⁶¹ e.g. transatlantic alliance cases *LH/SAS/UA* and *BA/AA*; *KLM/Alitalia*.

⁶² e.g. *British Airways/TAT*; *Lufthansa/SAS* (however with some flexibility).

⁶³ e.g. *Swissair/Sabena* (increases above 25% not allowed without prior approval).

⁶⁴ The period of time varies from case to case and it should allow the new entrant to establish itself as an effective competitor on the market (ea. 4 years in *Swissair/Sabena* and in *British Airways/TAT*; until such time as the new entrant actually operates on the market in *LH/SAS*).

⁶⁵ The reduction in frequencies applies for two years after entry and the parties' frequencies remain frozen at this lower level for four consecutive IATA seasons. A reduction of frequencies was also proposed earlier in the Commission's draft proposals in *Lufthansa/SAS/United* and *BA/AA* (Commission Notices, OJ C 239, 30.7.98).

⁶⁶ Provided that the parties could maintain a minimum number of frequencies to maintain connectivity between the parties' networks. The reduction corresponded with the overlap between the parties.

⁶⁷ The Commission also noted the relatively low average load factor on the route, which makes the route less attractive for a new entrant.

Interlining

The obligation to enter into interlining arrangements is another way to facilitate new entrants' access to the market, in particular to the market of time-sensitive passengers, which require flexible and seamless travel.⁶⁸ The remedies therefore traditionally include the obligation to enter into an interline agreement in respect of the routes concerned with the new entrant.⁶⁹

A novelty in *Austrian Airlines/Lufthansa* in comparison to previous cases is the proposed obligation for the parties, upon request, to enter into an interline agreement not only for travel on the problematical city-pairs between Austria and Germany but also for travel within and/or beyond Germany or Austria. Furthermore, while in the previous cases such interline agreements were to be made on "industry standard terms"⁷⁰, the proposed undertakings in *Austrian Airlines/Lufthansa* contain detailed specifications on the conditions for interlining, in particular with respect to pricing.

Blocked space agreements

The viability of a new entrant can also be enhanced by the fact that it will also be able to provide seats on the parties' frequencies under a blocked space agreement. This remedy was applied for the first time in *KLM/Alitalia*.

The proposed undertakings in *Austrian Airlines/Lufthansa* also include the obligation for the parties to enter into a blocked space agreement with a new entrant upon its request where the number of frequencies operated by the new entrant are less than the number operated by the parties. It is further specified that such blocked space agreement shall be based on a fixed number of seats⁷¹ and that the new entrant should carry the full commercial risk for the seats covered by the blocked space agreement.

Frequent Flyer Programmes (FFPs)

FFPs can act as a major barrier to competition since they favour airlines with large networks, which offer travellers greater chances to accumulate and use FFP points. Small and medium carriers may have too small networks to make such schemes attractive.⁷² Clearly the FFP of a dominant carrier at a hub is attractive to customers because its large network at the hub allows travellers (in particular business travellers) to collect more points and to redeem these points on a wider number of destinations. This raises a particular barrier for new entrants, which focus their activities on point-to-point passengers.

In several cases, the merger or alliance parties undertook to offer to new entrants who do not already participate in a FFP the possibility to participate in their FFP.⁷³

⁶⁸ As said in *British Midland v. Aer Lingus* (Commission decision of 26.02.1992 in case IV/33.544 - OJ L 96, 10.04.1992, p. 34), the absence of an agreement to interline may be a serious handicap for the airlines suffering from it.

⁶⁹ e.g. *British Airways/TAT*; *Swissair/Sabena*; *Lufthansa/SAS*; *KLM/Alitalia*.

⁷⁰ Including a reference to safety, creditworthiness, insurance coverage and reciprocity (e.g. *Swissair/Sabena*; *British Airways/TAT*; *KLM/Alitalia*).

⁷¹ Up to a maximum of 15% of the seats offered on a particular frequency and in any event not less than 12 seats and no more than 25 seats in a particular aircraft.

⁷² See Roundtable on airline mergers and alliances, Note by the EC Commission, October 1999, DAFNE/CLP/WD (99) 38.

⁷³ e.g. *British Airways/TAT*; *Swissair/Sabena*; *Lufthansa/SAS*; *KLM/Alitalia*.

CRS displays, travel agency schemes and corporate discounts

Besides frequency reductions, the Commission's decision in *KLM/Alitalia* also included two other new remedies. In particular, the parties undertook to reduce the size of their display on Computerised Reservation System (CRS) systems if this is necessary to allow a new entrant to appear on the first page of the display. Furthermore the parties undertook to refrain from applying remuneration schemes to travel agents in Italy or in the Netherlands which aim at securing the loyalty of travel agents to the parties on the relevant markets. The same obligation was applicable concerning fares offered to large corporate customers.⁷⁴

Participation in other alliances

In order to enhance the potential for inter-network competition, the Commission has in certain cases required the alliance or merger parties to terminate co-operation agreements with carriers, which also participate in other alliances.⁷⁵

Regulatory remedies

An important element in the Commission's analysis of the *Swissair/Sabena* merger was the declaration of the Belgian and Swiss governments that they will take the steps necessary to change, before 31 July 1995, the existing regulatory situation regarding the terms and conditions of access by air carriers to the routes between Belgium and Switzerland.⁷⁶

Regulatory remedies have also been discussed in the transatlantic alliance cases. In particular, in *LH/SAS/UA* and *BA/AA* the Commission indicated that it would be necessary to secure undertakings from the German, Scandinavian and UK authorities that they would authorise any Community carrier established in the EEA to operate direct and indirect services between any airport in their territory and the USA and to set its fares freely in order to ensure a sufficient degree of potential competition.⁷⁷

Other remedies

The Commission envisages introducing two further new remedies in the pending *Austrian Airlines/Lufthansa* case. The first concerns a commitment by the parties, each and every time that they reduce a published fare on a new entrant city pair, to apply an equivalent fare reduction (in percent) on three other Austria-Germany city pairs on which they do not face competition. The price reduction mechanism serves two purposes: it ensures that passengers, who fly on routes where the parties maintain a monopoly, benefit from competition and, as a side effect, it also makes it significantly more expensive for the parties to carry out a predatory pricing strategy.⁷⁸

The second innovation concerns the proposed obligation for the parties, upon request, to enter into an agreement with a railway or other surface transport company to provide an intermodal service. This remedy aims at enhancing the possibilities for railway operators to compete with

⁷⁴ These obligations were said to be without prejudice to the application of Articles 81 and 82 to such commission schemes. See in particular Commission decision of 14.7.1999 in case No IV/34.780 – *Virgin/British Airways* (OJ L 30, 4.2.2000).

⁷⁵ In *Swissair/Sabena*, Swissair undertook to terminate all effective co-operation with SAS under the European Quality Alliance. In *LH/SAS*, the Commission required SAS to terminate its agreement with Swissair and Austrian Airlines within the European Quality Alliance. It also concluded that Lufthansa had to terminate co-operation agreements with Finnair and Transwede on routes between Germany and Scandinavia.

⁷⁶ *Swissair/Sabena*, § 43 and 44.

⁷⁷ See Commission Notices, OJ C 239, 30.7.98.

⁷⁸ Note that a concern for predatory behaviour by the parties was also present in *Swissair/Sabena* where the parties undertook to abstain from scheduling flights for the sole purpose of obstructing new entries.

the parties and therefore to foster intermodal competition, which is one of the priorities of the Community's transport policy.

Conclusions

The Commission's approach to airline alliances and mergers is generally positive. By increasing network competition alliances can often bring significant benefits for passengers, particularly business travellers who want a seamless service and interlining travellers who generally see prices fall as a result of alliances. However, mergers and alliances can also reduce or even totally eliminate competition on routes where the allied companies were formally competitors. On hub-to-hub routes in particular alliances often have close to a 100% market share.

In practice, the Commission's policy so far has been to impose remedies, all of them designed to enable other airlines to enter the routes dominated by the alliance. In all cases the most important remedy imposed has been the surrender of airport slots to any new entrant and sometimes also a reduction or freezing of the frequencies flown by the alliance in favour of any new entrant.

There have been doubts whether past remedies have been entirely satisfactory in all cases. The Commission has therefore sought further means to make these remedies more effective. One way is to ask parties to find an "up-front" entrant on problem routes - an airline that wants to start or expand services so as to compete effectively with the alliance. Any slot and other remedies imposed can then be tailored to this competitor's needs, increasing the remedies' effectiveness.

However, difficult problems might arise when an up-front entrant cannot be found in particular where the overlap between the alliance partners' networks is substantial, passenger numbers high and potential entrants few and weak. The lack of adequate remedies in such circumstances might eventually lead to the prohibition of the proposed transaction.