

# **SAA II: Abuse of dominance in the South African skies**

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## **Abstract**

This article reviews an abuse of dominance decision against the incumbent domestic airline in South Africa (SAA) taken in 2010, and upheld on appeal in 2011. This case placed significant emphasis on the economic impact of the abusive conduct, and it represents a clear example of the adoption of an effects-based approach to assess exclusionary behavior by a dominant firm. As this paper sets out, given the features of SAA's conduct and of the relevant market context, it is also possible to identify a coherent economic framework which can explain why SAA's rivals could not profitably match its incentive schemes and were therefore foreclosed. The conceptual issues raised by the SAA case are similar to the ones at stake in the landmark judgments on *British Airways*. The lessons from this case are therefore relevant to the ongoing antitrust debate on loyalty discounts.

Keywords: Abuse of dominance, loyalty schemes, foreclosure.

## **1 Introduction**

This article reviews an abuse of dominance decision that was taken against the incumbent airline in South Africa (South African Airways (“SAA”)). SAA was found guilty of anticompetitive conduct by the Competition Tribunal of South Africa (“the Tribunal”) in February 2010.<sup>1</sup> The abuse consisted in the offering of retroactive incentive schemes to travel agents (much like in the *British Airways* case in Europe). This decision was upheld by the South African Competition Appeal Court (“the CAC”) in April 2011.<sup>2</sup> This case was the second complaint of exclusionary abuse brought against SAA, and is therefore referred to as “SAA II” in this article.

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<sup>1</sup> Competition Tribunal of South Africa, *Nationwide/Comair v. South African Airways*, Case No. 80/CR/SEPT06, 17 February 2010 (hereinafter referred as “CT (2010)”).

<sup>2</sup> Competition Appeal Court of South Africa, *South African Airways v. Comair/Nationwide*, Case No. 92/CAC/MAR10, 11 April 2011 (hereinafter referred as “CAC (2011)”).

The Tribunal's and the CAC's judgments in *SAA II*, taken together, provide an example of an abuse of dominance case that is steeped in an economic analysis of the effects of the conduct of the dominant firm, and that does not simply rely on a formalistic approach. The empirical analysis of foreclosure that characterises *SAA II* is rarely found in cases of exclusionary abuse, and it shows that decisions of this kind can be rested on an extensive evaluation of actual effects (subject to the availability of the relevant data). One of the aims of this article is to provide an account of the effects-based analysis that is contained in *SAA II*.

In common with European precedents on loyalty discounts, the two competition decisions on *SAA II* do not provide an explicit economic account for why SAA's smaller competitors were not in a position to match the incentive payments that the dominant firm offered to travel agents. On the other hand, in the specific context of incentive payments offered by airlines to travel agents, there are valid economic arguments for why one can expect smaller rivals not to be in a position to match the schemes used by a dominant firm.

The second main aim of this article is to fill this gap, by showing that it is possible to construct an economic theory that can explain, at the same time, why rivals could not match the incentives offered by a dominant firm like SAA, and why consumers were being harmed by the conduct. This economic theory crucially relies on the presence of asymmetric information between the recipients of the incentive payments (i.e. travel agents) and final consumers. Retroactive incentive payment can allow a dominant firm to efficiently exploit this asymmetric information at the expense of consumers, in a way that cannot be profitably matched by smaller competitors. The implication of this economic mechanism is that authorities should pay particular attention to abuse of dominance cases that share some of the essential features of the two SAA cases (and of similar precedents like *British Airways*).

On the other hand, the theory of harm presented in this article does not automatically carry over to more standard rebate cases whereby a dominant firm offers loyalty discounts to final consumers (or to retailers who have pricing discretion), under conditions of perfect information. This is because standard loyalty rebates do not leverage an informational disadvantage faced by final consumers, to the benefit of the dominant firm. This has important implications for the nature of foreclosure and of consumer harm, and also for the correct test to detect anti-competitive conduct. There is therefore merit in distinguishing the exclusionary mechanism at work in cases like *SAA II*, *SAA I* and *British Airways*, from those that might be relevant in other loyalty rebates cases (such as *Michelin II*, *Tomra* and *Intel*). By highlighting this distinction, this article also seeks to contribute to the ongoing debate on the appropriate legal and economic assessment of loyalty discounts.<sup>3</sup>

## 2 The cases against SAA

The first abuse of dominance case relating to SAA (which is referred to in this article as "*SAA I*") was decided by the Tribunal in July 2005.<sup>4</sup> In *SAA I*, the Tribunal found that the travel agent commission payment scheme implemented by SAA during the period between

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<sup>3</sup> See, for example, Faella (2008) and Zenger (2012), and references therein.

<sup>4</sup> Competition Tribunal of South Africa, *Competition Commission v. South African Airways*, Case No. 18/CR/Mar01, 27 July 2005 (hereinafter referred as "*CT (2005)*").

October 1999 and May 2001 was anti-competitive. This was primarily due to the fact that this scheme had a retroactive (or "back to Rand 1") structure.<sup>5</sup>

The 2005 decision by the Tribunal partially rested on the principles followed by European Commission in its landmark 1999 decision relating to similar conduct by British Airways in the UK market.<sup>6</sup> The Tribunal decision in *SAA I* also relied on fairly extensive evidence on the ability and incentives of travel agents to divert traffic between airlines (i.e. engage in so-called "directional selling") as a result of performance schemes such as the one offered by SAA. This evidence was based in turn on factual testimony from travel agents and airline executives, rather than on data on travel agent sales.

The *SAA I* decision only covered a relatively short period (19 months), since the case was referred to the Tribunal (by the Competition Commission) in May 2001. The decision therefore related to the period between the start of SAA's conduct (which the Tribunal established to be October 1999), and the date of referral to the Tribunal.

SAA's conduct continued in similar form (albeit with some adjustments) until mid-2005 (i.e. for almost a further 4 years beyond the period considered in *SAA I*). Shortly after the *SAA I* judgment of July 2005, SAA eliminated the retroactive design of its incentive contracts (with applicability from April 2005). This change in the contracts then formed part of a settlement agreement with the Competition Commission in May 2006 (confirmed by the Tribunal in December of that year).<sup>7</sup> The settlement did not contain an admission of liability for the period between May 2001 and March 2005. SAA's rivals in the South African domestic market (Comair and Nationwide) were however entitled to refer the case directly to the Tribunal, in order to seek to obtain a finding of infringement and thereafter pursue damages from SAA. Both parties decided to refer SAA's conduct during the 2001- 2005 period to the Tribunal.

This second case against SAA was heard by Tribunal in 2008 and in 2009, with a decision taken in February 2010. In its judgment the Tribunal found that SAA had abused its dominant position also during the period between May 2001 and March 2005. This finding stood despite the adjustments to the contract design implemented by SAA from contract year 2001/02, and also notwithstanding the changes in market circumstances which occurred during the post-2001 period (most notably, the entry of low-cost carriers from August 2001). SAA appealed the Tribunal decision to the CAC. The CAC upheld the decision of the Tribunal in April 2011.

At a conceptual level, *SAA II* relates to similar ground to the one already covered in *SAA I*. It also shares important similarities with the European decisions and judgments on *British Airways*, given that the conduct at stake was essentially the same. In particular, as it was the

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<sup>5</sup> SAA's conduct in both *SAA I* and *SAA II* is described more fully in section 5 below.

<sup>6</sup> *Virgin/British Airways*, Case IV/D-2/34.780, Commission Decision of 14 July 1999. This decision was upheld by the Court of First Instance in 2003 (*British Airways v Commission*, T-219/99, Judgment of the Court of First Instance of 17 December 2003); and by the European Court of Justice in 2007 (*British Airways v Commission*, C-95/04 P, Judgment of the Court of Justice of 15 March 2007).

<sup>7</sup> Competition Tribunal of South Africa, *The Competition Commission vs South African Airways (Pty) Ltd, Comair Ltd*, Case 83/CR/Oct04, December 2006. See also the 2006/2007 Annual Report of the Competition Commission, pp. 28-29. Under this agreement, SAA paid a fine in relation to the period until mid-2005, and agreed to use linear or incremental schemes in the future.

case in *SAA I*, the *SAA II* decision relied fundamentally on the same analytical arguments contained in the *British Airways* judgments on why SAA's smaller rivals could be not expected to profitably match the incentives offered by the larger airline.<sup>8</sup>

However, the *SAA II* decisions significantly extended the analysis of effects that is contained in *SAA I*, in terms of both the type of evidence used to demonstrate foreclosure, and the time period considered in the analysis (which was significantly longer). This distinguishes *SAA II* both from *SAA I* and, even more so, from the *British Airways* cases (which contained only an assessment of the potential of the conduct to lead to exclusion).

### **3 Market definition and dominance**

The issue of market definition was hotly debated in *SAA II*. This was not so much for its implications on the evaluation of SAA's dominance, but rather for its impact on the analysis of effects. Indeed *SAA II* is a good example of a case where market definition was not considered as an end in itself, but was primarily used as an analytical tool to properly isolate and identify the possible anti-competitive effects of the conduct of a firm with significant market power. Both the Tribunal and the CAC endorsed this view of market definition in *SAA II*, laying the basis for a sound effects-based analysis of SAA's conduct.

#### **3.1 Market definition: impact of the entry of low-cost carriers**

The main market definition issues at stake in *SAA II* revolved around the significant changes that had taken place in the South African domestic airline market since 2001. The low-cost carrier Kulula was launched by Comair in August 2001, and it was operated separately from its full-service subsidiary British Airways/Comair ("**BA/Comair**"). Kulula's entry was followed by another no-frills entrant (1Time) in 2004. By the end of the time period considered in *SAA II* (i.e. FY 2004/05), low-cost carriers had captured close to 20% of domestic flown revenues.<sup>9</sup> As part of their business model, Kulula and 1Time predominantly relied on the internet as their distribution channel, with limited sales made through travel agents.<sup>10</sup> They were therefore relatively immune to the potential foreclosing effect of SAA's conduct.

The growth of low-cost carriers between 2001 and 2005 raised the issue of whether the market definition adopted by the Tribunal in *SAA I* should be modified. In *SAA I* (in line with *British Airways*), the Tribunal had defined the affected market as the overall domestic airline market in South Africa, without distinguishing it by type of passenger and/or fare, or by route. This was a reasonable definition at the time given that by May 2001 no low-cost carrier had entered the market implying that travel agent sales constituted the overwhelming majority of domestic ticket sales. Moreover, a route-by-route definition of the market was not warranted given that SAA's conduct affected all domestic routes at the same time, by virtue of the fact the incentive schemes were based on total domestic sales made by travel agents.

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<sup>8</sup> The economic reasoning on foreclosure that is contained in the *British Airways* judgments has been criticised by a number of commentators, e.g. Bacon (2007) and Vickers (2009).

<sup>9</sup> CT (2010), paragraph 139 and table 4.

<sup>10</sup> Data available on Kulula indicated that it sold less than 10% of its tickets through travel agents in 2006 (see CT (2010), paragraph 82).

In the context of *SAA II*, this market definition question had significant implications for the effects that could be potentially attributed to SAA's conduct. A finding that the market should have been defined as a unique and largely undifferentiated market would have implied that bypass opportunities would have been available both to SAA's competitors and to its consumers. That is, SAA's rivals could have mitigated and circumvented much of the foreclosing effect of SAA's conduct by selling through the internet. Similarly, passengers would have been able to escape most of the associated consumer harm by buying their tickets online.

The evidence before the Tribunal pointed however to the presence of a significantly differentiated market, and arguably to the existence of separate markets for "time-sensitive" ("TS") and "non-time-sensitive" ("NTS") passengers (in line with the decision practice of the European Commission in several airline mergers assessed during the period covered by *SAA II*).<sup>11</sup>

This evidence included the following:

- The differences in the requirements of TS and NTS passengers (e.g. in terms of preferences for ticket flexibility), and the resulting well-established differences in the business models of traditional and low-cost carriers;<sup>12</sup>
- The fact that traditional full-service carriers (most notably SAA and BA/Comair) continued to rely primarily on travel agents for their sales, suggesting that online distribution was not an attractive route to market despite its lower cost. In BA/Comair's case, online sales never exceeded 5% of its total domestic revenues during the relevant period.<sup>13</sup> For SAA, its share of sales online only reached 5% at the end of the relevant period (i.e. in late 2004), due to the introduction of discounted online fares explicitly designed to compete with low-cost carriers;<sup>14</sup> and
- The extensive yield-management practices of the traditional carriers, which allowed them to maintain large fare differentials between premium/flexible tickets aimed at TS passengers and discounted fares designed for NTS, in competition with low-cost carriers. SAA's internal documents included reference to a "five-price" price differential between fares, identifying this as a feature of the traditional airline pricing model.<sup>15</sup> The ability to price discriminate supports the identification of narrower markets, since it allows traditional carriers to at least partially insulate TS passengers from the effects of more intense competition due to the entry of low-cost carriers.

Ultimately, the Tribunal did not depart from the definition of the market adopted in *SAA I*, and found in favour of unique market for domestic air travel in South Africa. However, it

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<sup>11</sup> See for example the European Commission's merger decisions on *AirFrance/KLM* (2004), and *Lufthansa/SwissAir* (2005).

<sup>12</sup> CT (2010), paragraphs 80-81 and 90-93.

<sup>13</sup> *Ibid*, paragraph 95.

<sup>14</sup> *Ibid*, paragraphs 119, 123 and ff. 77.

<sup>15</sup> *Ibid*, paragraph 123.

crucially recognized the extensive degree of product differentiation present in this market, on the basis of the evidence summarized above.<sup>16</sup> In doing so, it explicitly noted as follows:

*Recall that market definition is an analytical tool and that the exclusionary conduct we are concerned with are SAA's override incentive and trust agreements with travel agents and their effect, if any, on Nationwide and Comair in the domestic air travel market. In order to enable us to better understand the effects of SAA's agreements, it is important for us to appreciate this emerging market segmentation into price sensitive and non-price sensitive passengers but not necessarily to conclude firmly on such segmentation. (CT (2010), paragraph 133)*

Based on this conclusion, the Tribunal identified a "Travel Agent Segment", which included all tickets sold through travel agents and which comprised the higher-fare tickets. This market segment broadly overlapped with the market for TS passengers, but also included those NTS passengers who booked via travel agents. As the Tribunal explicitly stated a number of times in its judgment, the effects of SAA's behaviour on competitors and consumers, if present, would need to be located primarily in the Travel Agent Segment.<sup>17</sup> According to the data presented to the Tribunal, this segment represented the majority of revenues in the South African market (roughly 70% of it during the relevant period).<sup>18</sup> On appeal, the CAC readily accepted the Tribunal's approach on market definition and its implication for the analysis of effects.<sup>19</sup>

The evidence before the Tribunal and the CAC (notwithstanding the data limitations) arguably supported a narrower definition of the affected markets, and in particular a distinction between types of passengers. However, the choice of market definition was not determinative for the analysis of economic effects and the final outcome of the case. Ultimately therefore both the Tribunal and the CAC did not find it necessary to depart from the wide definition of the market used in *SAA I*, whilst stressing the importance of the degree of product differentiation present in the market and its implications for the case as a whole.

### **3.2 Implications for dominance**

In most antitrust cases, market definition has a direct bearing on the assessment of dominance, and therefore on whether an abuse of dominance can be identified. In *SAA II*, this issue was relatively straightforward to assess given the provisions of the Competition Act of South Africa. The statutory threshold for an irrebuttable presumption of dominance in South Africa is set at a market share of 45%. SAA's share of the market was above this threshold during the relevant period under any of the market definitions considered by the Tribunal, including a wide market comprising of all passenger types.<sup>20</sup> From a statutory

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<sup>16</sup> *Ibid*, paragraph 134.

<sup>17</sup> *Ibid*, paragraphs 133, 189, 190 and 204.

<sup>18</sup> *Ibid*, paragraph 134.

<sup>19</sup> CAC (2011), paragraphs 66 and 86.

<sup>20</sup> This was the case if one included in the computation of SAA's share also the revenues of its affiliate carriers South African Express (SAX) and South African Airlink (SAL). SAA's contracts with travel agents were based on the combined revenues of SAA, SAX and SAL, providing direct support for a computation of SAA's position in the market that was inclusive of the other two carriers (CT (2010), paragraphs 62 and 138).

perspective therefore the issue of dominance did not need to be analysed any further in *SAA II*.<sup>21</sup>

The measurement of SAA's share of the market, and the assessment of the significance of its market power, raised however issues of some economic relevance. The first was that the SAA's share of the relevant market (or segment) was significantly higher if one considered a narrower market/segment that included only travel agent bookings. For example, in 2004/05 (the last year of the relevant period), SAA's share of travel agent revenues was estimated by the Tribunal at 74%, whilst its share of total flown revenues stood at 58%.<sup>22</sup> By implication, SAA's size relative to its rivals was much greater in the narrow travel agent market than in the broader market. For example, SAA was more than four times larger than its closest rival BA/Comair in the narrow market, and only twice as large in the wider market (which included also Comair's other subsidiary Kulula).<sup>23</sup> A correct interpretation of the nature of product differentiation in the relevant market was therefore important for the assessment of SAA's market power, in particular in relation to its conduct towards travel agents.

The second significant issue in relation to SAA's dominance was that its share of the wide market had declined significantly during the relevant period, whilst its rivals had grown in the market. Between 2001/02 and 2004/05, SAA's share of total flown revenues fell from 71% to 58%, to the benefit of both Comair (including Kulula) and Nationwide.<sup>24</sup> SAA relied on this observation to argue that it did not hold market power (and also that its conduct did not foreclose competitors, which is a point I return to below in Section 6).

However, practically all of the market share loss suffered by SAA in the broad market was due to the market growth associated with the entry of low-cost carriers, and to the fact that SAA did not actively participate in such growth (at least for most of the relevant period).<sup>25</sup> In the event of market-growing entry by a competitor (i.e. entry of a new product which primarily captures new consumers), it follows automatically, other things being equal, that the loss in market share suffered by an incumbent firm (in percentage points) will be proportional to its pre-entry share of the market. It was therefore not surprising that SAA had suffered a larger reduction in market share than its rivals.

By contrast, according to the data used by the Tribunal, SAA (including SAX and SAL) did not experience a loss of market share in the narrower market including only travel agent sales, holding a market share in excess of 70% throughout the relevant period.<sup>26</sup> The Tribunal was therefore correct to be cautious when interpreting data on the evolution of market shares in the wide market, both in terms of their implications for market power and for the assessment of effects.<sup>27</sup>

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<sup>21</sup> CAC (2011), paragraph 73.

<sup>22</sup> CT (2010), Table 2 and Table 4.

<sup>23</sup> *Ibid*, Table 4 and Annex 1.

<sup>24</sup> *Ibid*, Table 4.

<sup>25</sup> *Ibid*, paragraph 203.

<sup>26</sup> *Ibid*, Table 1.

<sup>27</sup> *Ibid*, paragraph 202.

## 4 Characterising and evaluating SAA's conduct

The conduct at stake in *SAA II* was similar to that in *SAA I*, as both the Tribunal and the CAC found in their respective decisions. There were however some differences in SAA's incentive schemes in the two cases which are worth spelling out, as I do in Sections 4.1 and 4.2. In these two sections I also summarise the analysis of SAA's conduct that is found in *SAA I* and in *SAA II*, stressing some of the similarities with the European decisions on *British Airways*. In Section 4.3 I discuss an economic framework which can provide firmer grounding for the findings reached in *SAA II* (and by implication in *SAA I* and *British Airways* as well). Finally I also consider some of the potential efficiency implications of SAA's contracts (in Section 4.4), and the changes in SAA's contract design introduced from April 2005 onwards (in Section 4.5).

### 4.1 *The SAA I schemes*

In *SAA I*, the Tribunal considered the incentive contracts that SAA had in place with the majority of domestic travel agent market during the period October 1999 and May 2001. The Tribunal found that at the start of this period, SAA introduced a more demanding performance regime with domestic travel agents (relative to the previous performance scheme). Under the new scheme SAA paid travel agents a base commission of 7% of domestic revenues, independently of their sales performance. Agents could then earn two additional performance-related payments (known as "overrides"):

- A percentage "base override", which was payable if sales during a given contract year exceeded the level of the previous year (defined as "base revenues"). This base override was paid on a "back to Rand 1" (or retroactive) basis, meaning that the additional percentage commission applied to all the ticket sales made by the agent, and not just to those in excess of base revenues. During the period considered in *SAA I*, the base override offered by SAA was not constant, and could increase with performance.<sup>28</sup>
- A percentage "incremental override", which was paid by SAA in case of relatively high performance levels. This override was not paid on a "back to Rand 1" basis, but was instead paid "back to base". This means that it applied only on the increment between the actual performance achieved and base revenues.<sup>29</sup>

Both the base and the incremental overrides can be incorporated in an overall computation of the marginal commission faced by travel agents at different levels of sales performance.<sup>30</sup>

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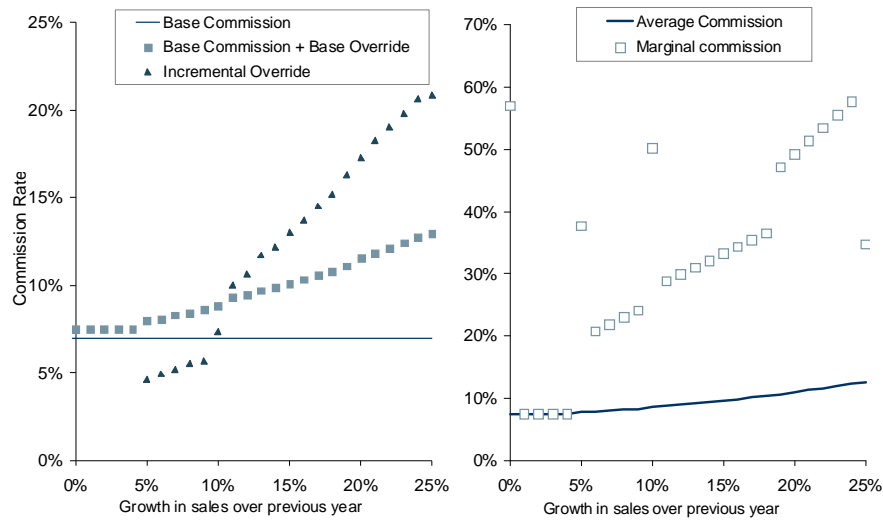
<sup>28</sup> For example, in the Renfin (Luxavia) agreement for 2000/2001 reported by the Tribunal in its 2005 decision, the base override was set at 0.5% for revenues between 0% and 4% in excess of base revenues, and then increased up to 1.55% for revenues 25% above base (see CT (2005), Appendix 1). Renfin (or Bidvest) was one of the largest domestic travel agents in South Africa during the period considered in *SAA I* and *SAA II*.

<sup>29</sup> In the Renfin agreement mentioned above, the incremental override kicked-in at sales that exceeded the base level by 5%. This percentage override ranged between 5% and 20% of incremental revenues (depending on the level of out-performance relative to base).

<sup>30</sup> The marginal commission captures the overall increase in total compensation received from SAA in return for a relatively small increase in sales. For example, if the relevant increment in sales used for the computation of marginal commission is set at 1% of base revenues, then the marginal commission rate implied by SAA's scheme with Renfin in 2000/01 jumped from 7% to 57% if revenues equaled the base level, and then increased again to within a range of 21% to 58% for performance levels in excess of 5% of base revenues. By contrast, the average



The override levels and implied commission rates under the Renfin contract are plotted in Figure 1.



**Figure 1: Incentive contracts in SAA I (Renfin)**

As Figure 1 shows, SAA's incentive scheme led to a large "wedge" between the marginal and average commissions paid to agents. In other words, SAA could provide strong incentives to agents at the margin without paying, on average, a particularly high commission rate.

In *SAA I* the Tribunal found that the high marginal commissions offered by SAA induced travel agents to divert passengers away from its rivals, and therefore foreclosed them. This finding was based on the fact that smaller rivals could not match the incentives offered by SAA by simply mimicking its retroactive incentive contracts (i.e. offering the same override schedules). Because of their smaller revenue base, if SAA's rivals were simply to replicate SAA's override contracts, the marginal payments that they would be offering would be lower than those available from SAA.<sup>31</sup> By the same token, matching the marginal incentives offered by SAA would have required rival airlines to pay much higher average commission rates, which according to the Tribunal would have not be affordable.<sup>32</sup> The Tribunal

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commission paid by SAA increased only gradually with performance, and only reached a level in excess of 10% at high out-performance levels (i.e. sales 17% above base).

<sup>31</sup> To consider a simple numerical example, suppose that in a given year a dominant airline has achieved revenues of €1m at a particular travel agent, and that its smaller rival had revenues of €100,000 at the same agent. The following year both airlines offer the *same* retroactive incentive contracts stipulating that their commissions will increase from 7% to 7.5% if the previous year's revenues (base revenues) are maintained. Suppose also that the agent has achieved sales of €990,000 and €90,000 respectively on each of the two airlines during the course of the second year, and that through its selling efforts it can direct a further €10,000 of business to one of the two carriers by the end of that year. In this situation, the override payment offered by the larger airline for the additional €10,000 of sales is therefore given by 0.5% times €1m, which equals €5,000. By contrast, the smaller airline is only offering 0.5% times €100,000, which equals €500. That is, the marginal commission offered by the smaller rival is only 10% of the one offered by the larger airline, by virtue of its smaller revenue base.

<sup>32</sup> The Tribunal stated its position as follows:

*[...] as the rivals are not dominant firms, their schemes whilst similar to SAA's, are always going to be ineffectual – they simply do not have the market share to change the incentives of travel agents unless*

therefore found that agents were induced to divert passengers towards SAA rather than favouring smaller carriers.<sup>33</sup>

The Competition Tribunal's conclusions in *SAA I* were very similar to those reached by the European Commission in *British Airways* in 1999. In that case, the European Commission had found that the retroactive incentive schemes offered by British Airways (“BA”) resulted in a marginal commission that was well above the average commission. For example, the European Commission computed that under BA’s scheme, if an agent maintained its sales with BA at the previous year’s level, it received a marginal commission of 17.4%, whilst the average commission stood at only 7.5%. According to the European Commission this meant the scheme offered by BA created a loyalty-inducing effect, at the expense of its rivals.<sup>34</sup> This conclusion was confirmed on appeal.<sup>35</sup>

#### 4.2 *The SAA II schemes*

SAA modified its incentive schemes again during the contract year 2001/02, in what appears to have been a response to the first investigation by the Competition Commission (after receiving the complaint from Nationwide). The changes introduced by SAA were in principle designed to reflect the outcome of the *British Airways* case in Europe.<sup>36</sup> The main adjustments introduced by SAA were the abolition of the incremental override, the use of simpler base override schedules, and the introduction of additional lump-sum payments known as “TRUST” payments.

To give an example of these changes, under one of the override contracts described by the Tribunal in *SAA II*, SAA offered a flat override of between 2% and 2.5% (depending on ticket type) at base performance (set at the previous year’s sales), with no incremental override and no increase in the base override as performance improved.<sup>37</sup> Relative to the schemes examined in *SAA I*, this resulted in a significantly larger upwards jump in marginal

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*they drastically increased the compensation to agents. Holt [the Competition Commission’s economic expert] argues that this would have to be to a level that is unaffordable to them* (CT (2005), paragraph 166).

In its *SAA II* decision, the Tribunal summarised the conclusions reached in *SAA I* as being that “A smaller rival, attempting to match the same cash value of the marginal commission payment offered by SAA, would have to pay much higher average commission rates” (CT (2010), paragraph 159).

<sup>33</sup> CT (2005), paragraphs 147-156, and 166.

<sup>34</sup> The European Commission stated in its Decision that: “Although BA also has to offer this high marginal rate of commission to increase its sales of tickets, it is at an advantage over the new entrant who must offer this high rate of commission on all of its sales” (paragraph 30).

<sup>35</sup> In its 2003 judgment, the Court of First Instance found that BA’s schemes had a fidelity-building character, “by reason of their progressive nature with a very noticeable effect at the margin” (paragraph 272), and that its rivals “were not in a position to attain in the United Kingdom a level of revenue capable of constituting a sufficiently broad financial base to allow them effectively to establish a reward scheme similar to BA’s in order to counteract the exclusionary effect of that scheme against them” (paragraph 278). The European Court of Justice confirmed the findings of the CFI in 2007, concluding in particular that CFI’s analysis of the exclusionary nature of BA’s discounts was correct, given their retroactive and individually negotiated nature (see in particular paragraphs 71-77).

<sup>36</sup> CT (2010), paragraphs 60 and 74; and CAC (2011), paragraph 78.

<sup>37</sup> CT (2010), Table 5. In other years, SAA offered a stepped base override schedule, with higher overrides percentages corresponding to different performance levels (e.g. base -10%, base -5%, base), as indicated by CT (2010), Annex 3.

commission at base performance (e.g. a marginal commission of 257% for premium fares), and lower marginal commissions thereafter (e.g. marginal rates of between 9% and 9.5%).

There was extensive evidence in *SAA II* that SAA had introduced TRUST payments to offset the abolition of incremental overrides, and therefore to keep encouraging sales beyond the attainment of base performance. TRUST was an acronym for “True partnership, Respect, Undivided Support, Sharing of information, and Training”.<sup>38</sup> Whilst Tribunal found that “SAA had developed a practice of not making written commitments in respect of trust payments, and had retained a fair amount of discretion in relation to the computation thereof”<sup>39</sup>, discovered evidence also cited by the Tribunal showed that TRUST payments were computed according to precise formulae, based on the revenue growth and market share achieved by each agent in relation to SAA’s sales.<sup>40</sup> Moreover, testimony from SAA’s former CEO indicated that TRUST payments had been designed to explicitly compensate agents for the switch away from the contract used in *SAA I*, and to preserve the loyalty-inducing effects of the agreements.<sup>41</sup> The level of these payments could be significant, representing a third or more of the total incentives offered by SAA.<sup>42</sup>

The evidence in *SAA II* was therefore that, in spite of the modifications introduced in 2001, the fundamental nature of SAA’s incentive payments to domestic travel agents had not changed. According to the Tribunal, the evidence on the nature of SAA’s conduct that emerged in *SAA II* “was no less persuasive” than the one relied upon in *SAA I* to conclude that SAA’s agreements provided incentives to agents to direct customer preferences.<sup>43</sup> The Tribunal also confirmed the finding that SAA’s rivals could not match its marginal incentives.<sup>44</sup>

In its judgment, the CAC endorsed the Tribunal’s conclusions in both *SAA I* and *SAA II* on the nature of SAA’s incentives schemes. It found that the significant payments offered by SAA to reach base revenues represented a strong incentive on travel agents in the face of a stagnant travel agent market.<sup>45</sup> It also confirmed the finding that in the face of overrides based on overall sales volumes, SAA’s smaller rivals would need to offer much higher average commission rates in order to match SAA, and that this made it particularly difficult for them to outbid SAA.<sup>46</sup> According to the CAC, “Comair and Nationwide were not in a position to grant travel agents the same advantages as SAA, as they were not capable of attaining a level of revenues capable of constituting sufficiently broad financial base to allow them to effectively match the override rates offered by SAA”.<sup>47</sup>

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<sup>38</sup> CT (2010), paragraph 68.

<sup>39</sup> *Ibid*, paragraph 71.

<sup>40</sup> *Ibid*, paragraph 68 and Table 1.

<sup>41</sup> *Ibid*, paragraphs 74, 160-161, 174, and 177.

<sup>42</sup> *Ibid*, paragraph 72.

<sup>43</sup> *Ibid*, paragraph 180.

<sup>44</sup> *Ibid*, paragraphs 175 and 231.

<sup>45</sup> CAC (2011), paragraphs 97-98.

<sup>46</sup> *Ibid*, paragraphs 100-101.

<sup>47</sup> *Ibid*, paragraph 102.

### 4.3 *The need for an economic theory of matching and of consumer harm*

From an economic perspective the arguments provided in *SAA I* and in *SAA II* for why smaller rivals to SAA could not profitably match the incentives provided by the incumbent airline are intuitive, but incomplete. This reasoning relies on the observation that in order to match a given *marginal* incentive offered by a large incumbent, a smaller rival would need to pay out a higher *average* commission than the incumbent. This allegedly puts the smaller rival at a competitive disadvantage, and it does not allow it to profitably match the incremental incentives offered by the dominant firm.<sup>48</sup>

However, if the passenger volumes that travel agents are able to divert to their favoured airline are worth the same to each competitor, it is not immediately clear why competition for these “divertible” passengers should not take place on an equal footing, despite the differences between the implied average commission rates highlighted in *SAA I*, *SAA II* and also in *British Airways*. In particular, competing carriers should presumably be willing to offer as an incentive payment to agents a monetary amount that equals the level of total profits that can be extracted from divertible passengers. The fact that expressing this payment as a percentage of the total commission paid by each airline results in a higher average commission for the smaller carriers (given their more limited revenue base) should be immaterial to whether or not competition for travel agent support is taking place on a level-playing field.<sup>49</sup>

Given the nature of the conduct at stake in the SAA cases and the role played by travel agents, *there is* however a coherent economic explanation for why one would expect smaller competitors not to be able to match the incentive payments offered by a larger incumbent. This explanation goes beyond the reasoning that was put forward in the *SAA* and *British Airways* judgments, and it helps to provide an analytical underpinning for the conclusion that was reached in these cases concerning the inability of rivals to match the dominant firm.

The economic theory of anti-competitive foreclosure which can be applied to *SAA II* rests on the evidence that SAA’s incentive payments induced travel agents to exploit the asymmetric information faced by consumers with respect to the fares and availability of competing carriers in the market, and as a result provided them with incentives to divert some passengers to SAA (I return to this evidence below). To do so, agents effectively reduced direct “head-to-head” competition in the market, by making SAA’s rivals less visible to passengers. This in turn enabled SAA to capture additional passengers through the purchase of travel agent support rather than by offering consumers lower prices. SAA thus was able to obtain additional passengers at higher prices than those which would have resulted if competition had not been impeded by the incentive contracts.

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<sup>48</sup> This line of reasoning was recently confirmed by the European courts in their judgments on *Tomra* (see *Tomra v Commission*, Case T-155/06, Judgment of the General Court of 9 September 2010; and *Tomra v Commission*, Case C-549/10, Judgment of the European Court of Justice of April 19 2012).

<sup>49</sup> For a more general discussion of this point in the context of recent European cases on exclusionary discounts such as *Tomra* and *Intel*, see Federico (2011).

Given its richer network offering, SAA can be expected to have been able to extract *more* value from diverted passengers (in terms of higher prices and greater volumes) relative to its rivals. This is because, on average, and by virtue of SAA's dominance, passengers would have found SAA's overall product offering more attractive than that of its rivals. To take a simple example where a travel agent would be able to divert 100% of its consumers to a given airline through directional selling, on average those consumers would find the product of the dominant firm more appealing than those of a rival firm (e.g. because of the dominant firm's denser network). When competing for the so-called "directional selling" services of that travel agent, the dominant firm would therefore be able to offer a greater incentive payment than its smaller rivals, since it would be able to extract more surplus from consumers.

In a context where competition can be softened by travel agents through directional selling, the larger firm can therefore be expected to be able to extract higher rents from the market than smaller firms. This in turn implies that the larger firm should be able to consistently outbid its competitors for travel agent support, as both the Tribunal and the CAC found in *SAA II*.<sup>50</sup> This explanation holds especially in circumstances where there is significant asymmetry in the size and network offerings of the competing carriers (which was the case in South Africa<sup>51</sup>, and to a large but lesser extent also in *British Airways*<sup>52</sup>).

Moreover, contrary to more conventional exclusionary mechanisms, the dominant firm does not need to sacrifice profits in the short-run in order to outbid its rivals. Obtaining travel agent support can be expected to be profitable (net of the incentive payments) given the fact that diverted passengers can be exploited by offering them less favourable economic terms (relative to a counterfactual with no travel agent favouritism). This in turn suggests that future recoupment (i.e. higher prices in the future) is not required for the conduct to make economic sense.

The economic mechanism described above suggests that SAA's conduct also had an exploitative connotation, in addition to the more standard exclusionary one. That is, under this framework consumers would be harmed by the conduct *also* in the short-run, through the effects of the incentive schemes on the quality of the information provided by the travel agents, and the resulting softening of competition between carriers.<sup>53</sup>

This non-predatory account of SAA's schemes indicates that it would have not been appropriate to assess the conduct using the analytical framework for conditional rebates contained in the recent European guidance paper on exclusionary abuse.<sup>54</sup> The guidance

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<sup>50</sup> For a formal exposition of this economic argument see Federico and Régibeau (2012). This "monopoly persistence" result is present also in other areas of industrial economics, such as the analysis of investments in R&D (see Tirole (1988), Chapter 10). Other models of exclusion where incumbents can profitably outbid their competitors when offering exclusive contracts to other third parties (e.g. upstream providers or downstream retailers) include Jing and Winter (2012) and Abito and Wright (2008).

<sup>51</sup> This is shown by the figure on the shares of the Travel Agent Segment held by SAA which are discussed in Section 4 above.

<sup>52</sup> See the European Commission's 1999 decision on *Virgin/British Airways* (paragraphs 88 and 94), and the Court of First Instance 2003 judgment on *British Airways v. Commission* (paragraphs 210-211).

<sup>53</sup> This mechanism reinforces and complements the finding reached by the Tribunal in *SAA I* that consumers were harmed as a result of directional selling by travel agents, by making the "wrong choice of airlines", and at "wrong prices". See CT (2005), paragraph 242.

<sup>54</sup> See European Commission (2009).

paper puts forward a quasi-predatory test for retroactive rebates, designed to establish whether the dominant firm's effective prices are below the appropriate measure of costs on the "contestable" part of the market. In the SAA case, this test would have not properly captured the abusive conduct, since SAA's contracts may well have been profitable at the margin (i.e. on the part of the market that travel agents were able to divert from one carrier to another), whilst at the same time being capable of excluding rivals and harming consumers. A finding that SAA's conduct was not loss-making at the margin would have therefore not implied that its incentive scheme was unlikely to lead to anti-competitive foreclosure.

In principle, it could have been possible to apply an adjusted price-cost test to SAA's rivals, by asking the question of whether they could have been able to profitably match SAA's incentives payments. However, this test would have been difficult to implement empirically since, if the economic mechanism discussed here is correct, matching SAA's scheme would have *just* been unprofitable for its rivals in equilibrium (assuming profit-maximising behaviour by both sets of firms).<sup>55</sup> Distinguishing between profitable and unprofitable matching in this context would have been hard, and subject to considerable measurement error.<sup>56</sup> This consideration, together with the overall evidence on the distortionary and exclusionary nature of SAA's incentive schemes, supports the Tribunal's decision to reject the application of a quasi-predatory test to SAA's conduct.<sup>57</sup>

More generally, it is important to note that whilst the economic framework set out above can provide a coherent account on why a dominant airline may be able to profitably outbid its smaller competitors in order to obtain support by travel agents, it does not directly apply to the more standard settings where loyalty schemes (e.g. discounts) are offered to final buyers or to intermediate buyers with price-setting discretion (e.g. as applicable to other landmark cases in Europe, such as *Michelin II*, *Tomra* and *Intel*). This is because in the standard case, loyalty rebates do not leverage an informational asymmetry to the benefit of the dominant firm and at the expense of both rival firms and consumers. This has direct implications for the nature of foreclosure and of consumer harm, and also for the correct test to detect anti-competitive conduct. It is therefore appropriate to distinguish the exclusionary mechanism at work in cases like *SAA II*, *SAA I* and *British Airways*, from those that might be relevant in more conventional loyalty rebates cases.

#### **4.4 Countervailing efficiencies**

An important aspect of the evaluation of SAA's conduct was also whether the incentive scheme could have been expected to generate any significant economic efficiencies. In *SAA I*, the Tribunal rejected an efficiency defence for SAA's contracts, primarily on the grounds that travel agents were not able to set ticket prices and therefore could not seek

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<sup>55</sup> This is not the case in standard predation cases, where the size of the loss suffered by the prey in the short-run is relevant to the likelihood of success of the exclusionary strategy (since it affects the prospects of future recoupment for the prey and thereby its probability of exit).

<sup>56</sup> In addition, uncertainty on the value of divertable passengers would have made SAA's rivals particularly cautious when bidding for travel agent support, due to so-called winner's curse considerations. Economic theory indicates that asymmetries between bidders (such as the one present in this case due to SAA's dominance) can exacerbate winner's curse effects, placing smaller bidders at a disadvantage (see for example, Bulow *et al.* (1999)).

<sup>57</sup> CT (2010), paragraphs 145-146.

to meet SAA's incentive targets by lowering prices (benefitting consumers in the process).<sup>58</sup> The same feature applied to *SAA II*, and indeed is an important reason for why the theory of consumer harm described above holds.<sup>59</sup> When agents receive an incentive payment from airlines to divert traffic, they do not have the ability to pass-through that incentive to consumers. This inevitably limits the potential pro-competitive effect of the conduct.

A separate mechanism through which incentive contracts with travel agents could lead to efficiency is by encouraging travel agents to compete harder for corporate accounts, by offering lower service fees or better services.<sup>60</sup> This effect too was unlikely to be significant given the design of SAA's incentive contracts. Under these schemes, growth in revenues obtained by travel agent as a result of the acquisition of an existing in-house corporate account from a rival travel agent did not count towards meeting the incentive targets.<sup>61</sup> In other words, if an agent grew by capturing a new corporate client, the SAA target would typically be adjusted upwards accordingly. This shut down one of the most plausible channels through which the scheme could have increased efficiency, by leading to more intense competition for large corporate clients. By implication, it also meant that the primary mechanism through which agents could meet their incentive target was to divert some of their *existing* business from one airline to another, therefore leading to an exclusionary effect. The Tribunal ultimately dismissed any efficiency justification in *SAA II*.<sup>62</sup>

#### **4.5 Features of the post-2005 remedy**

SAA changed its incentive schemes with domestic travel agents from April 2005, following the Tribunal's decision on *SAA I*, in order to mitigate further competition risk. The changes introduced by SAA were in line with the 2006 settlement agreement (see Section 2 of this article).<sup>63</sup>

In relation to the design of the incentive schemes, under this settlement SAA committed to two main measures: (a) the removal of retroactive commissions, to be replaced by linear incremental commissions; and (b) the use of uniform sales targets across travel agents, which could only be differentiated to the extent that this reflected cost savings.<sup>64</sup> SAA's contracts of 2005-06 complied with this remedy by setting the level of base revenues at which the retroactive override kicked-in at a very low (nominal) value, which all agents were sure to meet. For example, in the case of Renfin base performance was set at 1% of the

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<sup>58</sup> At paragraph 251 of this judgment, the Tribunal found as follows:

*There is no evidence of how, armed with their superior knowledge of SAA product, [travel agents] put more people on to planes. The most obvious method by which they might do this is to provide lower prices on SAA tickets so as to promote air travel – but the evidence suggests that they cannot do so and indeed are discouraged from intra brand competition between agents as, according to Mortimer, SAA does not want to lose control over its pricing.*

<sup>59</sup> CT (2010), paragraph 230.

<sup>60</sup> Given the predominantly corporate focus of the travel agent market, this effect could have been potentially relevant in *SAA II*.

<sup>61</sup> CT (2010), paragraph 66.

<sup>62</sup> CT (2010), paragraph 240. The CAC did not deal with efficiencies as SAA did not appeal this part of the decision (CAC (2011), paragraph 147).

<sup>63</sup> *Ibid* (2011), paragraphs 47-48, and CT (2010), paragraph 13.

<sup>64</sup> CAC (2011), paragraph 49.

previous year revenues. This change effectively transformed the commission scheme from retroactive to linear.<sup>65</sup>

The 2006 settlement was broadly in line with the “Principles” on travel agent commission published by the European Commission in July 1999, in the wake of the *British Airways* case.<sup>66</sup> These Principles were designed to provide guidance to dominant airlines on how to avoid violating abuse of dominance provisions.

One key difference between the SAA settlement and the *British Airways* Principles was that under the latter airlines could not differentiate the level of commissions across travel agents, unless differences could be justified by value or cost-based factors. The *British Airways* Principles therefore effectively prohibited airlines from engaging in “perfect (or first-degree)” price discrimination, forcing them to move to what is known in the economic literature as “second-degree” price discrimination. Under the latter, all agents are offered the same incentive schedule, independently of their size. A standard result in the economic literature is that a switch from first- to second-degree price discrimination leads to lower marginal incentives for all agents except the very large ones. This follows from the fact that under second degree price discrimination the principal finds it too costly to provide strong incentives to small agents at relatively low performance targets (since these incentive payments would then need to be granted also to larger agents for their infra-marginal sales).<sup>67</sup>

The switch from a retroactive to a linear incremental design that is part of both the *SAA II* settlement and of the *British Airways* Principles can also be expected to lead to lower marginal commissions. This is because it becomes more expensive for the principal to offer high commissions at the margin, if these commissions also need to be applied to infra-marginal sales by the agent. This in turn can reduce or eliminate the incentive to induce travel agents to divert passengers to the larger airline.

Under its settlement scheme with the Competition Commission however, SAA could still discriminate across travel agents in terms of the level of the override commission that it paid to them. Indeed, there was evidence that SAA was paying different commission rates to travel agents in 2005/06. Therefore, even if the commission paid to agents was simply a flat rate and it did not depend on the achievement of a particular sales target within a given year, under the terms of the settlement SAA was still able to lower such rate during the following year for a specific agent if performance by that agent was deemed not satisfactory. This possibility may have discouraged agents from moving too much traffic away from SAA for fear of losing part of SAA’s override in the future. This effect could be expected to blunt the pro-competitive impact of the change in SAA’s conduct introduced in 2005-06.<sup>68</sup> I return to the interpretation of the evidence on the period after the change in SAA’s contracts in the following section of this article.

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<sup>65</sup> *Ibid*, paragraphs 50-51.

<sup>66</sup> European Commission, *Commission sets out its policy on commissions paid by airlines to travel agents*, Press Release IP/99/504, July 14 1999.

<sup>67</sup> See for example Bolton and Dewatripont (2005), Chapter 2.

<sup>68</sup> CAC (2011), paragraph 51.



## 5 Assessing the effects of SAA's conduct

What really sets apart the two competition judgments on *SAA II* from most decisions on abuse of dominance is their extensive analysis of the exclusionary effect of SAA's conduct. This is the case even if one compares *SAA II* to the earlier decision in *SAA I*, and it is even more so by comparison to the competition judgments in *British Airways*. *SAA II* examined two broad categories of evidence on effects, which I deal with in turn below. The first consisted of evidence on travel agents (which was most directly relevant to the conduct at stake), whilst the second related to the broader domestic airline market.

### 5.1 Evidence of effects on travel agents

The Tribunal and the CAC looked at two types of evidence on the effects of SAA's incentive schemes on travel agents.

The first, which was the primary piece of evidence on effects in *SAA I*, was based on discovered evidence and testimony from both travel agents and airlines on whether agents were able to engage in directional selling as a result of the financial inducements offered by airlines. In *SAA I*, the Tribunal had concluded that this was indeed the case because of the asymmetric information present between agents and travelers on the prices and availability of airline tickets.<sup>69</sup> In order to reach this conclusion, the Tribunal mainly relied on the evidence provided by agents during the competition hearing (including two large groups like Sure Travel and Tourvest).<sup>70</sup>

In *SAA II*, this finding was confirmed. The Tribunal and the CAC relied on documentary evidence and testimony from two large travel agent groups (Sure Travel and Bidvest) to reiterate the finding that agents were in a position to divert passengers between carriers in response to the financial inducements offered by airlines.<sup>71</sup> Moreover, SAA itself, including

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<sup>69</sup> The Court of First Instance reached a similar finding in its 2003 judgment on *British Airways*:

*Nor, in order to deny the fidelity-building effect of its performance reward schemes on travel agents, can BA successfully rely on the argument that those agents have only a slight influence on travellers' choice of airlines. BA has itself argued that those agents provide a useful service filtering information communicated to passengers who are faced with the proliferation of different air transport fare structures (paragraph 274).*

<sup>70</sup> Mr. Puk of Sure Travel testified as follows during the hearing for *SAA I*:

*ADV PRETORIUS: So I am asking you again, which one is really paramount to the Managing Director of a firm, the consumer or the incentive, reaching the incentive threshold? Mr Puk from your point of view, what is most important?*

*MR PUK: From my personal point of view, if you are asking for the paramount, I am employed to make sure that the group achieves its preferred agreements. (CT (2005), paragraph 195)*

Mr. Mortimer of Tourvest gave the following evidence during the same hearing:

*MR MORTIMER: [...] it certainly would be in our commercial interest to promote our preferred. It's very simple. We are not going to make any profit out of selling a non-preferred's ticket. We're going to basically break even on trading. If we're going to make profit, we're going to make profit because we sold a preferred carrier;*

*[...] wherever we have the opportunity we promote our preferred supplier and that can and has been at times highly lucrative and it is on that basis that we are able to achieve our volume incentives and generate profitability in our business. (CT (2005), paragraphs 201-202)*

<sup>71</sup> Both the Tribunal and the CAC quoted the following communication from Mr Puk of the Sure Travel group to managers of the agencies within the group, in the context of the reduction in base commissions announced by SAA in mid-2005 (which was unrelated to the competition law proceedings):

in its Annual Report for 2006, indicated that it considered that agents could engage in directional selling.<sup>72</sup> The Tribunal and the CAC also explicitly rejected the notion that the growth of online bookings and of low-cost carriers had reduced the degree of asymmetric information present between agents and passengers, in part due to the continued reliance on yield management systems by traditional airlines (implying “constantly changing prices available to consumers”).<sup>73</sup>

The second key category of evidence on the effects of SAA’s conduct on travel agents was based on discovered data on travel agent sales by carrier. In particular, Comair provided cross-sectional data on the sales performance of its subsidiary BA/Comair at the various domestic travel agents. BA/Comair’s performance was measured by its share of the total annual sales by each agent, defined as Billing and Settlement Plan (“BSP”)<sup>74</sup> revenues.<sup>75</sup>

This evidence was used to compare BA/Comair’s performance at travel agents loyal to SAA (i.e. those that had incentive contracts with the incumbent airline, and which had indicated to BA/Comair that they intended to achieve the SAA targets<sup>76</sup>), and those that for whatever reason, at least during part of the relevant period, were not supporting SAA.

The latter included in particular American Express (Amex) during the contract years 2001/02 and 2002/03. During this two-year period Amex did not have an incentive agreement in place with SAA due to a contractual dispute. The data showed that during this period, BA/Comair’s share of BSP sales at Amex increased by 9 percentage points (from 27% to

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*It has become very clear that we cannot rely on saa for a decent override agreement in future and our basic commission is about to disappear altogether. [...] Therefore, I am formally advising you that our group strategy is to move our discretionary business away from saa onto more agent friendly carriers [...] We need to show saa in the months of Feb/Mar/ & April that travel agents are still vital to their business and that we can and will, direct the business away from them.* (CT (2010), paragraph 148)

The CAC found that Ms Harris of the Rennies Group (part of Renfin), “confirmed that travel agents in the Rennies Group had a discretion, with which to influence customers”, based on the following testimony at the SAA II hearings:

*ADV UNTERHALTER: But I think you will also accept, as I think you have, but there is this ambit of discretion and within it you are exercising a judgment in formulating the recommendation?*

*MS HARRIS: Correct.*

*ADV UNTERHALTER: And I think you also would accept given all of this that it is a complex judgment, not just because of the many factors that are involved in it, but also because you are trying to make an assessment of, as it were, an answer which is meant to summarise all kinds of different preferences that are made up within a corporate as you have described there are many interests, many specific preferences and you are trying to, as it were, summarise all of that up and say well ultimately this is the recommendation that we have is that correct?*

*MS HARRIS: That is correct.* (CAC (2011), paragraph 125).

<sup>72</sup> This report read as follows (again in the context of the reduction of base commissions implemented by SAA in mid-2005): “At first the trade directed business to our competition before the other airlines followed suit cutting commissions some 6 months later.” (CT (2010), paragraph 155).

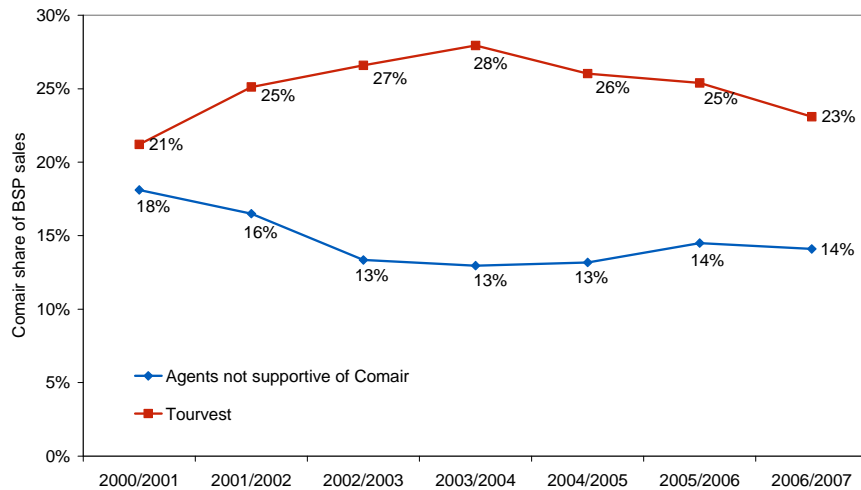
<sup>73</sup> CT (2010), paragraphs 147 and 156; and CAC (2011), paragraphs 87 and 125-126.

<sup>74</sup> BSP revenues were also used in the European Commission’s decision on *British Airways* to measure travel agent sales.

<sup>75</sup> The corresponding data on SAA’s other domestic competitor (Nationwide) was not as extensive, and did not allow for the same type of analysis.

<sup>76</sup> These agents accounted for roughly 80% of BSP during the relevant period.

36%), whilst its share with agents that supported SAA dropped by 5 (from 18% to 13%).<sup>77</sup> A similar, but more muted, trend could be observed when comparing agents loyal to SAA to the Tourvest group. This group included, in addition to Amex, the travel agent Seekers which, contrary to Amex, had an agreement with SAA during the period.<sup>78</sup> This second trend is illustrated in Annex 2 of the Tribunal's 2010 decision, and is reproduced as Figure 2 here.



Source: South African Competition Tribunal (2010), based on BSP data from Comair

Notes: Agents not supportive of Comair refer to agents that have not supported Comair at any point during the period between 2001/02 and 2004/05. These agents exclude Tourvest, Concorde and Prestige and account for roughly 80% of BSP over the period.

**Figure 2: BA/Comair's performance by travel agent grouping**

This evidence was supportive of the proposition that travel agents could divert traffic between airlines in response to incentive schemes, as both the Tribunal and the CAC found.<sup>79</sup> It was also particularly instructive since, by virtue of its cross-sectional nature, it largely “controlled” for market-wide forces which could have potentially affected the relative performance of SAA and of BA/Comair in the marketplace (e.g. a change in the relative quality of their offerings, or the entry of low-cost carriers). Such changes, if existent, would have expected to affect sales across travel agents in broadly similar ways, and therefore could not explain the significant divergences in BA/Comair’s performance by travel agent that were evident in the data.

Additional data available on the absolute levels of travel agent sales by company also gave a measure of the extent of foreclosure of Comair in the part of the market sold through travel agents (i.e. the "Travel Agent Segment" defined by the Tribunal). This data showed that

<sup>77</sup> CT (2010), paragraph 150; and CAC (2011), paragraph 116. During the same period, SAA's share at Amex dropped by 6 percentage points, whilst its share at Bidvest (the largest domestic travel agent group) increased by approximately 5 points (CAC (2011), paragraph 117).

<sup>78</sup> CAC (2011), paragraphs 89 and 144.

<sup>79</sup> CT (2010), paragraphs 218 and 221; and CAC (2011), paragraph 118. Note that the existence of a contractual dispute between SAA and Amex during the relevant time period may have directly contributed to the increase in BA/Comair’s share of sales at Amex. This implies that BA/Comair’s performance at Amex relative to other agents may not represent a direct measurement of the impact of the conduct at stake (i.e. the use of retroactive incentive schemes by SAA). Nonetheless, the Amex evidence showed that travel agents were able to engage in directional selling if they faced incentives to do so (independently of the source of these incentives).

during the overall relevant "abuse" period (measured from 1999/00 to 2004/05 inclusive<sup>80</sup>), SAA's absolute sales through travel agents increased by 16%, whilst BA/Comair's sales fell by 14% (a relative performance gap of 30 percentage points).<sup>81</sup> This data also indicated that BA/Comair's relative loss of sales through travel agents was stronger than through other distribution channels, which was also to be expected given the nature of SAA's conduct.<sup>82</sup> This evidence was also consistent with the significant reduction in BA/Comair's share of BSP between 2000/01 and 2004/05.<sup>83</sup>

The quantitative evidence on travel agents therefore not only supported the finding reached by both the Tribunal and the CAC that agents could divert traffic to SAA in response to its incentive schemes, but also showed that BA/Comair had suffered a significant reduction in travel agent sales (relative to SAA) as a result. The Tribunal found that the cross-sectional evidence on travel agents, coupled with their importance as a distribution channel and with qualitative documentary evidence, allowed it to "*conclude that foreclosure of its rivals by SAA in the domestic airline travel market was likely to be substantial and that this impact would have been greater on that segment of the market which was distributed through travel agents and which consisted of the higher price fares*" (paragraph 224).

## **6.2 Evidence of effects in the broader domestic airline market**

In *SAA I*, the Tribunal sought to examine foreclosure effects in the overall domestic airline market, but could only consider passenger data over a short time period, between late 2000 and mid-2001. Whilst this data showed a relative decline for Comair and Nationwide, it was not sufficiently extensive to support a firm conclusion on the extent of foreclosure in the domestic airline market.

By contrast, in *SAA II* much more comprehensive data was available, not only on travel agent sales (as discussed above), but also on flown revenue and passengers in the market as a whole, over a longer time period.

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<sup>80</sup> This period measures effects during both the *SAA I* (2000/01) and *SAA II* (2001/02-2004/05) periods. The fact that the conduct assessed in this case took place during two contiguous time periods implies that in order to measure its effects (even in the context of *SAA II* alone) it is appropriate to consider the overall affected period, rather than just the second period starting in mid-2001. Given the evidence that SAA's conduct during the second period in part "locked-in" the gains made during the first period, looking only at the second period evidence would lead to an under-estimate of the overall foreclosure effects (CT (2010), paragraphs 197 and 212).

<sup>81</sup> CAC (2011), paragraphs 115 and 144.

<sup>82</sup> CT (2010), paragraph 217.

<sup>83</sup> During this period BA/Comair's suffered a reduction from 18% to 13% in its share at agents supportive of SAA, which accounted for the overwhelming share of total domestic BSP revenues.

### ***Evidence in relation to Comair***

The analysis of foreclosure in the overall domestic airline market raised issues that are closely linked to the market definition question already discussed in Section 3 of this article. In particular, in the case of Comair (which was the closest competitor to SAA through its full-service subsidiary BA/Comair), one central issue was whether the performance of its subsidiary Kulula should be taken into account for the purposes of measuring its relative performance in the market. This matters because, including Kulula, Comair had increased its share of the market during the relevant period, whilst without Kulula it has lost market share.

Based on the arguments that I have already summarised, the Tribunal found that Kulula's growth had taken place in a different market segment than the one most affected by SAA's conduct.<sup>84</sup> Using the growth of Kulula to effectively offset the decline in BA's performance therefore risked obfuscating the foreclosure effect of SAA's conduct, especially in relation to competition for TS passengers. Moreover, the evidence indicated that the Kulula would have been launched independently of SAA's conduct, and therefore that much of its growth would have been observed also in a counterfactual without the conduct. The most appropriate benchmark for the purposes of assessing foreclosure was therefore given by Comair's relative performance *without* Kulula.<sup>85</sup> This was equivalent to the performance of the full-service subsidiary BA/Comair.

The evidence on BA/Comair showed that it had significantly underperformed SAA during the overall abuse period (as summarized in Table 1 below).<sup>86</sup> Between 1999/00 and 2004/05, BA/Comair's flown revenues had grown by 13%, whilst SAA's had increased by 38% (a differential performance of 25 percentage points). Most of this discrepancy was due to relative performance in terms of yields (i.e. average revenues) on BA/Comair's domestic routes, which increased considerably more for SAA than for BA/Comair during the period.

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<sup>84</sup> *Ibid*, paragraph 204.

<sup>85</sup> In response to this argument, one might reason that in relation to those passengers for which BA/Comair and Kulula would have competed in the counterfactual (i.e. NTS passengers), SAA's conduct implied that Comair faced stronger incentives to compete via Kulula, since BA/Comair was foreclosed. Kulula's growth would therefore be partially explained by the conduct. However, for this consideration to be empirically relevant, one would require the foreclosure effects of the conduct to also apply to NTS passengers willing to book tickets online, either via Kulula or BA/Comair (which seems unlikely). In other words, it is more likely that the foreclosing effects of SAA's conduct were concentrated in a part of the market for which Kulula did not compete to any significant extent. The evidence reviewed below on the *relative* performance of SAA and of BA/Comair supports the claim that this was not significantly driven by competition from low-cost carriers.

<sup>86</sup> See also CAC (2011), paragraph 118.

**Table 1: Comparison of SAA and BA/Comair overall performance during the period 1999/00 – 2004/05**

Changes between 1999/2000 and 2004/05	SAA	BA/Comair
Flown revenues (Rand million)	864	90
Flown revenue (% change)	38%	13%
Flown passengers ('000)	176	-6
Flown passengers (% change)	5%	-1%
Yields* (Rand)	208	85
Yields* (% change)	33%	13%

\* Refers to yields on the four domestic routes served by BA/Comair during the relevant period.

Source: CT (2010), table 6 at p. 59.

This evidence was consistent with SAA's conduct having had both a foreclosure effect on Comair, and an adverse effect on consumers. As a result of its conduct, SAA should be expected to have captured a greater number of high-yield TS passengers, therefore increasing both its flown revenues and its average yield, as the data indicated. This was also in line with the evidence from travel agent sales. Moreover, the increase in SAA's average yields was also consistent with SAA being able to raise its relative prices as a result of the softening of competition induced by its conduct. It also showed that SAA had outperformed BA/Comair in revenue and passengers terms not by cutting fares, but by actually becoming more expensive.

Both the Tribunal and the CAC accepted the validity of this evidence of foreclosure and of consumer harm. Whilst the Tribunal indicated it was "wary" of placing excessive weight on evidence on revenues, passengers and yields without considering it in the broader evidentiary context<sup>87</sup>, it was able to conclude that the evidence on SAA's higher yields was indicative of harm to consumers.<sup>88</sup>

The CAC's findings on the foreclosure effects on BA/Comair actually went beyond those of the Tribunal. The CAC found that the evidence on BA/Comair's revenue and yield underperformance supported a conclusion that SAA's conduct had exclusionary effects.<sup>89</sup> Moreover, the CAC explicitly considered, and rejected, the alternative accounts for the evidence that had been put forward by SAA. These alternative explanations rested on three separate lines of reasoning (that were not necessarily mutually compatible):

- i. *That BA/Comair had been "cannibalized" by the introduction of Kulula.* According to this possible account of the evidence, BA/Comair had been harmed more than SAA by the entry of Kulula in 2001, thus explaining its underperformance. However, this account failed to recognize that Comair owned Kulula and therefore faced an incentive to "direct" its competitive pressure towards SAA, and, to the extent possible, away from BA/Comair. Indeed, SAA reacted to Kulula's entry by introducing cheaper tickets (X-fares) in 2004. Moreover, the ownership link between

<sup>87</sup> CT (2010), paragraph 200.

<sup>88</sup> *Ibid*, paragraph 248.

<sup>89</sup> CAC (2011), paragraphs 121, 127 and 128.

BA/Comair and Kulula implied that BA/Comair faced weaker incentives to compete on price against Kulula, relative to SAA. If Kulula has been such an important driver of the relative performance of full-service carriers, one would have therefore expected BA/Comair's yields to *increase* relative to SAA (as it lost low-yield passengers, without responding by cutting prices), but the evidence indicated the opposite.<sup>90</sup> Finally, even if it were true that SAA was "immunized" against the threat posed by Kulula relative to BA/Comair, this could well have been a consequence of the incentive contracts with travel agents.<sup>91</sup>

- ii. *That SAA had been relatively more exposed to competition from low-cost carriers, thus suffering a loss of low-yield passengers.* This explanation is of course almost the reverse of the Kulula "cannibalization" theory reviewed above, but it could at least explain the evidence on relative yields. If it were true that SAA had lost more NTS passengers than BA/Comair as a result of the expansion of low-cost carriers, its relative yields could have increased through a composition effect (i.e. due to the fact that the composition of SAA's passengers would have shifted towards a higher yield mix). However, this theory could not explain the evidence on revenues and passengers, which showed that SAA outperformed BA/Comair in these two dimensions, despite its alleged greater exposure to competition from low-cost carriers. By contrast, the exclusionary interpretation of SAA's incentive contracts with travel agents could simultaneously account for the evidence on revenues, passengers and yields.<sup>92</sup>
- iii. *That SAA's overall product offering had improved relative to BA/Comair.* In principle the evidence on performance in the airline market would also be consistent with an improvement in the quality of SAA's product relative to BA/Comair, since this would be associated with a relative shift of demand towards SAA, and therefore higher revenues and yields. SAA had indeed argued that several of its attributes (e.g. its frequency, route network, and loyalty programme) were superior to those of BA/Comair, and could explain its better performance. The CAC however pointed to a range of evidence which showed that during the relevant period the quality of BA/Comair's product offering appeared to have matched that of SAA. The Court therefore rejected also this third alternative explanation for the evolution of the domestic airline market.<sup>93</sup>

Having considered and rejected these three potential alternative explanations for the evidence on BA/Comair's foreclosure, the CAC was able to confirm the Tribunal's finding that SAA's conduct had an anti-competitive exclusionary effect on its main competitor.<sup>94</sup>

#### ***Evidence in relation to Nationwide***

Whilst the evidence on BA/Comair's relative performance in the overall domestic airline market was consistent with SAA's incentive agreements having had an anticompetitive

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<sup>90</sup> *Ibid*, paragraphs 118-121, 137-138 and 145.

<sup>91</sup> *Ibid*, paragraph 145.

<sup>92</sup> *Ibid*, paragraphs 122 and 123.

<sup>93</sup> *Ibid*, paragraph 132.

<sup>94</sup> *Ibid*, paragraphs 127, 133 and 146.

effect, the evidence with respect to Nationwide, the smaller domestic competitor, was more difficult to interpret. This is because Nationwide had grown its share of the market during the relevant period, despite SAA's conduct. The evidence however also showed that it done so at the expense of its relative yields. Whilst before the abuse period, Nationwide's yield differential with SAA was of just under 40%, by the end of the abuse period (in 2004/05) it had grown to close to 60%. By contrast, Nationwide's yields dropped closer to those of Kulula during the period, with the corresponding yield differential decreasing from close to 40% in 2001/02 to less than 20% in 2004/05. As the CAC found, this data (coupled with the overall evidence on the effects of SAA's travel agent agreements) indicated that the Nationwide had grown primarily in the NTS segment of the market, and that it had been foreclosed from the high-yield part of the market due to SAA's conduct.<sup>95</sup> This conclusion was confirmed by documentary evidence on Nationwide's difficulties in securing travel agent support during the relevant period.<sup>96</sup>

### ***Evidence on the post-abuse period***

The final piece of evidence considered to evaluate foreclosure effects was the relative performances of BA/Comair and Nationwide after the end of the abuse period (that is, from mid-2005 until roughly mid-2007, which is when the available data ended). Particularly in relation to BA/Comair, the data showed that whilst there was some improvement in its performance after mid-2005 (for example, in terms of sales through travel agents and yields), the overall evidence indicated that its recovery was relatively muted.

The Tribunal did not place much weight on this data, partially on the grounds that little additional evidence was available on the post-abuse period to be able to place it into a broader context.<sup>97</sup> It therefore opted to base its findings on the foreclosure effects that could be observed during the abuse period (relative to the pre-abuse period), in addition to the evidence on the ability and incentives faced by travel agents to engage in directional selling.

Whilst the CAC did not explicitly consider the post-abuse period in its judgment, it noted the significance of the imperfections of the consent order that applied to SAA's conduct post mid-2005, particularly the fact that it still allowed for rate discrimination across travel agents (as discussed in Section 5.5 above).<sup>98</sup> This argument, coupled with the possibility that the distortionary effects of exclusionary conduct may have a long-lasting impact that continued also during the post-abuse period (by e.g. affecting consumer preferences, or locking-in incumbency effects)<sup>99</sup>, supports the position of the Tribunal on the post-2005 evidence.

## **7 Conclusion**

For reasons that are set out in this article, the judgments against SAA taken by the Competition Tribunal in 2010, and by the CAC in 2011, are a clear example of the use of a rigorous effects-based approach to the evaluation of exclusionary conduct by a dominant

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<sup>95</sup> *Ibid*, paragraphs 123, and 141-142.

<sup>96</sup> CT (2010), paragraphs 226 and 228.

<sup>97</sup> *Ibid*, paragraphs 220-224.

<sup>98</sup> CAC (2011), paragraph 51.

<sup>99</sup> For a general discussion of this point, see European Commission (2011), paragraph 134.



firm. This case was characterized by the availability of comprehensive evidence on the actual foreclosing effects of the conduct of SAA. This consisted both of qualitative information on the ability and incentives of travel agents to shift passengers between airlines (from internal documents, and testimony), and of quantitative evidence on the relative performances of the competing airlines in the market. The latter included extensive data on market shares at travel agent level and on overall revenues and yields, over a fairly long time period (5 years or more). This rich set of data complemented the qualitative evidence that the Tribunal had relied upon in its previous decision on similar conduct in 2005, allowing the Tribunal and the CAC to reach a firmer conclusion on the actual (as opposed to likely) exclusionary effects of SAA's conduct. The wealth of evidence used to support a finding of anti-competitive foreclosure makes *SAA II* an example of best practice in the adoption of an effects-based approach in abuse of dominance investigations.

In terms of the evaluation of the form of the contracts used by the dominant firm, in *SAA II* both the Tribunal and the CAC followed a traditional approach, finding that the retroactive design used by SAA implied that its smaller rivals would not be able to replicate the effects of the contracts. For reasons given in this article, this approach should be supplemented by additional economic considerations in order to rest on a stronger analytical underpinning. In particular, the economic framework described in this paper can explain why smaller firms should not be expected to have been in a position to profitably match the incentive payments offered by the SAA, and why these schemes could result in consumer harm. These economic considerations are also applicable to the landmark judgments on *British Airways* in Europe. They can therefore contribute to a better understanding of loyalty schemes used by dominant firms as part of the ongoing antitrust debate on this issue.

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