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AIRLINE COMPETITION

-- Expert Paper by John Balfour --

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AIRLINE LIBERALISATION AND COMPETITION: THE EU EXPERIENCE
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The international background

Traditionally, the airline industry has not been a competitive industry. A fundamental reason for this may be found in the fact in the early days almost all airlines in the world (with the notable exception of the US) were State-owned, and regarded by States as "flag carriers" and valuable national assets. This thinking was codified in the 1944 Chicago Convention, which continues to lay down the ground rules for international civil aviation. Its very first Article confirms that each contracting State has complete and exclusive sovereignty over the airspace above its territory, and Article 6 makes clear the logical consequence of this - that no scheduled international air service may be operated over or into the territory of a State without its special permission. Limited exceptions to this rule were agreed by the States party (currently some 130) to the accompanying so-called "Two Freedoms" Agreement, which permits aircraft of States party to overfly and make stops for non-traffic purposes in any contracting State (the first and second freedoms of the air respectively). The more ambitious so-called "Five Freedoms" Agreement makes exceptions with regard to the third, fourth and fifth freedoms of the air (ie, the right for an airline from a State to carry passengers from that State to another, and vice versa, and the right to carry them on from that other State to a third State and vice versa) but is currently only effective as between eleven States.

As a result, there grew up a worldwide network of bilateral air services agreements, under which States granted each other the right for their airlines to operate air transport services between their territories. Such traffic rights were generally granted on a limited, quid pro quo, basis, and with the aim of protecting the national carrier and therefore prohibiting or severely restricting competition. Hence, they generally limited capacity and frequency, and often limited operations to a single designated airline, prescribed the use of particular designated airports only and required the approval of both States for fares. Moreover, they were frequently accompanied by "pooling" agreements between the airlines concerned, under which the airlines agreed to share equally the revenues earned by them on their flights between the two States, which clearly removed any incentive to competition.

The Convention also provides (in Article 17) that aircraft have the nationality of the State in which they are registered. The introduction of national laws in most States requiring aircraft registered on their national registers to be owned and controlled by local nationals restricted aircraft ownership on a national basis, and helped to confirm the notion of airlines as "flag carriers". Furthermore, the provision in most bilateral air services agreements permitting a State to withhold or withdraw traffic rights from an airline of another State if that airline is not substantially owned and effectively controlled by that other State and/or its nationals reinforced this and ensured that the airline industry developed on strictly nationally demarcated lines.

The European background

The Treaty of Rome came into effect, for its then six member States, in 1958. Its principal purpose, the creation of a common market by abolishing national barriers to trade, was fundamentally incompatible with the nationally demarcated way in which the international air transport business had developed and was regulated. Consequently, what appeared to be an exception was made for air transport, by the Treaty's stating that its provisions on transport policy did not apply to (sea or) air
transport, and that it was for the Council to decide whether, to what extent and by what procedure appropriate provisions should be laid down for air transport. The requirement for unanimity in Council decisions on such matters meant that any one State could block any liberalisation initiatives. Hence air transport in Europe continued to function as though the EEC (as it then was) did not exist for almost 30 years.

In the meantime, in 1978 the US deregulated its domestic air transport industry, and this development was carefully observed by the Commission and gave impetus to its attempts to propose similar deregulation in Europe. Then, in 1986 and 1987 two things happened that together helped to clear the blockage and open the way to liberalisation: the judgment of the European Court of Justice in the so-called "Nouvelles Frontières" case and the signature of the Single European Act amending the Treaty of Rome, respectively.

There were at the time some who believed that the Treaty's provisions on air transport policy, mentioned above, meant that air transport was effectively exempt from all aspects of EEC law. The main point at issue in the Nouvelles Frontières case was whether this was the case or whether air transport was nevertheless subject to the "general rules" in the Treaty - i.e., those other than specific provisions on transport policy, which, importantly, included the competition rules. In its judgment in 1986 the Court held that the latter was the case, thereby giving the Commission a weapon with which to threaten member States in respect of allegedly anti-competitive practices engaged in by their airlines. The Commission's hand was strengthened the following year by the amendment of the Treaty by the Single European Act so as (among other things) to change the requirement for unanimity in the Council for the adoption of air transport legislation to a requirement for qualified majority.

EU liberalisation

The combination of legally backed threats of enforcement action by the Commission and the knowledge that initiatives could now be adopted by the Council by qualified majority led to the Commission's proposal of the measures that came to be known as the "first package", and their adoption by the Council in 1987, to have effect from 1 January 1988. These fairly modest first steps towards liberalisation of air transport in Europe were followed by a slightly more ambitious set of measures in 1990 (the "second package") and then by the much more radical and far-reaching "third package", effective as from 1 January 1993. In contrast with US deregulation, which happened all at once, EU liberalisation was a deliberately phased process, taking place over a five year period.

The first two packages liberalised rules on access and fares, requiring member States to permit certain limited types of air services and air fares within certain "zones of flexibility". The third package not only removed the remaining qualifications to liberalisation of access and fares, so that any EU licensed carrier was entitled to operate air services between any two points within the EU (even two points outside its home State - so-called "seventh freedom" services - and two points within a State other than its home State - cabotage services), and set fares as it wished, but also introduced common rules on air carrier licensing. While at first sight these appear to consist of somewhat bureaucratic requirements that an applicant must satisfy if it is to obtain an operating licence, the corollary that a member State is obliged to grant an operating licence (and thus the right to operate services between any two points in the EU) to any applicant satisfying the requirements had two radical effects. In the first place, member States could no longer operate a monopoly policy in favour of their national carrier as regards intra-EU services. Secondly, the fact that one of the
requirements to be satisfied by an applicant for an operating licence was majority ownership and effective control by any EU member State and/or its nationals (in place of the previously applicable requirement for such ownership and control by the home State and/or its nationals) meant that a member State could no longer refuse to grant an operating licence to an applicant airline on the grounds that it was owned and controlled by nationals of an EU member State other than itself (for example, a subsidiary of an airline from another member State).

**EU liberalisation and the competition rules**

The first package contained not only legislation liberalising access and fares, but also the first EU legislation on air transport and the competition rules - an "implementing" regulation, giving the Commission the powers necessary for effective enforcement of the rules, and a regulation empowering the Commission to grant "block exemptions" from the then equivalent of Article 101(1) of the Treaty on the Functioning of the EU. The former was necessary because, although the Court had held that the competition rules applied to air transport, enforcement of them in practice was difficult in the absence of such an implementing regulation. The latter indicates the gradual, phased approach adopted also as regards the application of the competition rules. In the early years, certain types of agreement and practice common in the airline business were exempted from the application of the rules - perhaps most significantly IATA tariff coordination conferences - but these were gradually reduced in number and scope, and now no such block exemptions apply. A gradual, phased approach was also taken to the geographical scope of implementing provisions for the rules: initially they were limited to international services between EU member States; domestic services within member States were then included; and finally services between member States and third countries were included in scope.

In an industry where market access is strictly regulated, and thus proper competition does not exist (as was the case with the airline industry in most of Europe until the late 1980s), competition rules may be seen to be inappropriate. However, the more access to a market is liberalised, the more important it becomes to control the behaviour of the participants in that market. This was recognised at an early stage in the EU, and consequently increasing deregulation by way of liberalisation on the one hand was accompanied on the other hand by increasing regulation by way of application of the competition rules, in two complementary processes.

**The EU competition rules**

The EU competition rules may be broken down into four main components:

- Article 101, prohibiting agreements, decisions and concerted practices preventing, restricting or distorting competition, subject to the possibility of exemption

- Article 102, prohibiting abuse of a dominant position

- Council Regulation 139/2004 (the Merger Regulation) requiring transactions between companies involving a change of control, where specified turnover thresholds are met, to be notified to the Commission for approval

- Article 107, prohibiting aid by a member State distorting competition by favouring a particular undertaking or undertakings, subject to the possibility of exemption.

These rules are all of general application. In addition there is an aviation-specific Regulation, Council Regulation 868/2004, empowering the Commission to take
action in respect of aid by non-member States to their airlines, but these powers have not been exercised to date.

Overview of the application of the competition rules in the airline sector

There have been relatively few decisions by the Commission enforcing Article 101 in the airline sector and also few reported cases of its being used in litigation in national courts (although there have been decisions of national authorities, a discussion of which is beyond the scope of this paper). In fact, there was only one such decision, that issued in July 2001 imposing fines totalling €52.5 million on SAS and Maersk for market-sharing\(^1\), until the major decision issued by the Commission in November 2010 imposing fines totalling €799 million on eleven airlines for operating a cartel on cargo fuel and security surcharges\(^2\). In February 2011 the Commission announced the opening of investigations into codesharing arrangements between Lufthansa and Turkish Airlines and between TAP and Brussels Airlines, but no decision has yet been issued.

The Commission has more frequently applied Article 101 in the context of applications for exemption for joint operation and cooperation agreements between airlines – most recently those between the core members of the oneworld and Star alliances, and such investigation as regards the Skyteam alliance is pending. In each case the Commission has granted the exemption applied for, although in many cases subject to the parties agreeing to substantial commitments designed to mitigate adverse effects on competition – most importantly by way of agreement to give up slots at congested airports to enable the launch of competing services.

There have also been relatively few cases of enforcement of Article 102 (and of its use in national litigation). Apart from two early cases concerned with refusal to supply\(^3\), and a series of decisions concerning ground handling and charges at airports, the only such decision has been the Commission’s 1999 decision imposing a fine of €6.8 million on British Airways for operating incentive schemes which rewarded travel agents with additional commission in return for meeting sales targets\(^4\).

The Commission has issued some 32 decisions under the Merger Regulation in respect of concentrations between airlines\(^5\), some of which have been between non-EU airlines (e.g., most recently, in 2013, American Airlines and US Airways) where the required EU turnover thresholds were met. In most cases the Commission has permitted the proposed concentration, often subject to the parties agreeing to substantial commitments, as in the case of airline alliances, but in three cases, all concerned with concentrations between airlines from the one and the same State, it has issued a prohibition decision, on the grounds that the effects on competition would be unacceptable and incapable of remedy by commitments. Two of these decisions, in 2007 and 2013, concerned Ryanair’s attempt to acquire control of Aer Lingus, and the other, in 2011, the proposed merger between the Greek airlines Aegean Airlines and Olympic Air, although the Commission cleared unconditionally a further proposed merger between these two airlines in 2013, on the grounds that the circumstances had changed significantly since the time of the previous application, and also that the “failing firm defence” applied in respect of Olympic\(^6\).

Since 1991 the Commission has examined a large number of cases involving possible State aid to airlines. Some of these cases were not taken further, on the basis that the measure in question was in accordance with the “market economy investor (or operator) principle”, but in many cases the Commission issued formal decisions permitting the aid measure subject to conditions (generally intended to
ensure that the aid is used for restructuring and not for anti-competitive purposes, and that no further aid will be granted, or in the case of rescue aid that it complies with the Commission’s normal conditions for rescue aid), and in a few cases it prohibited the implementation of the proposed measure or (where already implemented) required the repayment of the aid. In the 1990s the cases were mainly concerned with attempts by airlines to restructure in order to meet the demands of the newly competitive market, and the Commission’s approach was therefore generally to allow aid for such purposes provided it was indeed properly used for such purposes, and that no further aid was given. Two cases, concerning Alitalia and Olympic, occupied much of the Commission’s time and effort over several years till 2008, when they were finally resolved, in similar ways, essentially by privatisation.

Indeed, in the early years the cases occupying the Commission largely concerned the principal State-owned airlines, and the main aim of enforcement action was to ensure that they were not allowed to compete unfairly with smaller independent airlines. However, in February 2004 the Commission showed, to the surprise of some, that large State-owned airlines were not the only target of the rules, when it issued a decision holding that certain financial assistance given by Charleroi Airport (owned by the Walloon Region of Belgium) to Ryanair constituted State aid ineligible for exemption\footnote{7}. This decision was followed by the issue in 2005 of guidelines by the Commission on start-up aid for routes from small and peripheral airports\footnote{18}, and by Commission investigations into and decisions on a number of other similar arrangements. However, the judgment of the Court of First Instance in December 2008 annulling the Commission’s 2004 decision on the grounds that it had not properly applied the market economy investor principle\footnote{19} necessitated a rethink by the Commission of its approach, and the (eventual) result was the publication in February 2014 of revised guidelines and a re-opening of the Charleroi case.

Assessment

Airline liberalisation in the EU has been a great success, despite the initial challenges created by the traditional system based on strict demarcation on national lines\footnote{20}. After a slow start, probably due largely to weak economic conditions in the early 1990s, the legislative changes introduced by the three packages of liberalisation have radically changed the airline scene in the EU, with the emergence, and indeed preponderance, of low-cost carriers, such as easyJet, Ryanair and Air Berlin, significant changes by the traditional “legacy” airlines in their business models and pricing practices, a large increase in the number routes operated and points connected and strong downward pressure on fares\footnote{21}. Moreover, State ownership of the major airlines in each member State, almost universal 30 years ago, has now almost entirely disappeared - not as a direct result of liberalisation, but undoubtedly as an indirect result of it. All this has been achieved by the forces of competition that liberalisation made possible, in many member States for the first time.

The application of the EU competition rules, with a view to avoiding the emergence of anti-competitive practices in a newly liberalised environment, has also played an important role in this achievement, but whether the record in this area has been equally successful may be more open to debate. While it may be pointed out that there has been relatively little enforcement action by the Commission in respect of anti-competitive practices in this sector, it should also be borne in mind that there is a practical limit to the extent of enforcement by the Commission, and the lack of enforcement action (and also the lack of litigation in national courts) may well demonstrate rather that there has been little need for it and that airlines have learned to live with and comply with the rules.
Perhaps the biggest question arises over the success of the Commission's approach with regard to concentrations and alliances. The result of this has been to allow the industry to become largely concentrated into the three global airline alliances - Star, oneworld and Skyteam, both at an EU level (with Lufthansa's acquisitions of Austrian, Swiss and Brussels Airlines and the British Airways/Iberia and Air France/KLM/Alitalia arrangements) and at an international level (the latter, of course, requiring the approval also of the competition authorities in the US and other relevant States). It has been argued that this has resulted, among other things, in the consolidation of 15 competing airlines on the north Atlantic into three competing alliances over the 20 year period from 1991 to 2011, with consequent disbenefits for consumers. On the other hand, it has often been pointed out that, due to the history of State ownership and "flag carriers", there are still more long-haul airlines in Europe than the market would seem to justify, particularly when compared with the situation in the US, and therefore that some consolidation is called for. Moreover, the emergence of the global alliances has meant that passengers on many long-haul routes now have a clear choice between at least three different options, although this choice does not exist for passengers on hub-hub routes (eg, London- New York, Paris - New York, Frankfurt - New York) who wish to travel non-stop and are not willing to travel via an intermediate point. These very different considerations have been recognised by the Commission in its approach to the crucial definition of relevant markets for the purposes of airline concentrations and alliances, as has the fact that such options are generally not available in the case of short-haul routes (except in the case of cities served by more than one airport).

As mentioned above, many airline concentrations and alliances have been permitted by the Commission subject to conditions (or remedies, as they are frequently known), generally involving the giving up of slots at congested airports in order to help promote new competition, and it is therefore relevant to ask how successful such conditions have been at encouraging new competition. It has to be said that, initially at any rate, little if no advantage was taken of such opportunities. This was recognised by the Commission, which therefore in its decisions concerning Iberia/Vueling/Clickair and Lufthansa/Austrian in 2009 sought to strengthen the remedies - for example, by obliging the parties to try to find new entrants up front, requiring the availability of slots to be advertised, and doing more to help new entrants establish a mini-base at the hub airport in question. However, even such strengthened remedies appear to have failed to have a significant effect. A study by Airneth in 2011 of seven airline merger cases in which slot remedies had been imposed found that on 36% of city-pairs with remedies new entry had taken place, but that this had reduced to 20% after two years, and that new entry was substantially lower on long-haul routes than on short-haul. Moreover, there was substantial new entry only after the Iberia/Vueling/Clickair concentration in 2009, principally by way of Ryanair's entry onto a number of Spanish domestic routes, and it was by no means certain either that Ryanair's entry was due to the slot remedies, or that it represented an acceptable substitute for all types of passengers. It is therefore doubtful whether, even with the strengthened new approach, the remedies imposed in airline concentration and alliance cases have had any significant remedial effect. However, it is not easy to envisage any further or better conditions or remedies that could be available, and the alternative approach of outright prohibition would fail to address the need for consolidation in the industry, although in certain exceptional cases there may be no alternative given the unavailability of any effective remedies, as the Commission found to be the case with Ryanair/Aer Lingus.

It is appropriate also to make some comment on the time taken by the Commission to conduct investigations and issue decisions, the record being very different as regards investigations into concentrations on the one hand and other investigations.
Thanks to the strict timetables and deadlines imposed by the Merger Regulation, investigations into concentrations take place with great expedition - indeed, one might say remarkably so, given the amount of data and complexity of the issue involved. This may be contrasted with the approach to alliance cases, which involve similar issues but are not governed by the Merger Regulation's strict timetables. The Commission's decision on the alliance between the core members of the Star Alliance took four years, and a decision on the Skyteam alliance is still pending, eight years after an initial statement of objections was issued, although this initial investigation was closed and the current investigation opened in December 2012. Four and a half years passed between the opening of the Commission's investigation into the alleged cargo surcharges cartel and the issue of its decision (which has still not been published, almost four years later). Furthermore, the Commission's investigation into two codesharing arrangements has now been in progress for over three years, which is particularly concerning from a practical point of view given the fact that such arrangements between airlines have been common for some years.

As regards State aid, it may be said that the enforcement record is somewhat mixed as regards restructuring aid. Generally, a more lenient approach in the early years has been replaced by a tougher approach, although the long and difficult (albeit eventually successful) experience with the Olympic and Alitalia cases demonstrates the political sensitivity of the issue and the difficulty which the Commission faces in practical enforcement of its decisions. While it is obviously right that the rules should be applied not only to legacy airlines but also in the case of aid by State-owned airports to (normally low-cost) airlines, it is unfortunate not only that the Commission's decision in the first important test case, concerning Charleroi Airport and Ryanair, turned out to be incorrect but also that the Commission took more than five years to react to the Court's judgment in clarifying its approach and revising its guidelines on the subject, although at least that has now happened.

Other barriers to competition

Following removal of legislative constraints, the most important remaining barrier to competition in the internal EU air transport market (other than the type of anti-competitive behaviour that the competition rules are intended to control) is the availability of slots at congested airports - ie, the right for an airline to use the runway at an airport for landing and take-off at particular times. This was recognised, if not at an early stage during the liberalisation process, at least shortly afterwards, as demonstrated by the Commission's proposal that was adopted as Regulation 95/93 on common rules for the allocation of slots at Community airports in 1993. This Regulation basically gave legislative recognition to the system of slot allocation that had been developed by IATA and in force at airports throughout the world for many years - based on "grandfather rights", ie, the right for an airline that has used a slot for at least 80% of the time during a traffic season to be granted that same slot in the subsequent equivalent traffic season. This provided some legal certainty, which was welcome to incumbent airlines, although less so to others, because, by essentially approving the existing status quo and enshrining it in legislation, it favoured incumbents and did not do much to assist would-be new entrants in obtaining slots at congested airports. Over the 20 or so years that the Regulation has been in force there have been several studies on its possible amendment, one actual amendment and one proposed amendment currently in progress. However, the essential features of the Regulation remain very much as in the original Regulation, and will do even if the current proposal is adopted as proposed. Although the studies have examined the available options exhaustively, the conclusion has always been that it would not be in the general interest radically to change the traditional system,
which gives airlines, and passengers, the certainty (at least from the point of view of slots) that the same scheduled services may be operated and offered season after season. This is of course at the cost of protecting incumbents and making new entry more difficult, but experience has shown that there are market solutions to this problem, in the form of the sale and purchase of slots. An active slot market has developed particularly at Heathrow Airport, following an important English High Court judgment in 1999 confirming that such transactions were in accordance with the Regulation**28**, although such practices have been slow to develop at airports in other member States. After some initial reluctance to accept this, the Commission has now been persuaded of the new entry benefits and embraced the idea of secondary slot trading, provided the process is made more transparent than it currently is, and its proposal which is currently going (slowly) through the legislative process includes provisions on the matter. Also, as mentioned above, the importance of slots for competition has been recognised in the frequent inclusion of slot remedies in Commission decisions on concentrations and alliances, although the practical results of such remedies have been less significant.

The principal legacy airlines enjoy an inheritance not only of slots at the major hub airports, but also of a long established route network, reputation and market position. This is a result of the history and way in which the industry has developed, and it would be disruptive and disproportionate to seek now to undo these historical benefits. However, it is important for competition authorities to carefully monitor that there is no abuse of what will in many cases be a dominant position. The Commission’s action against British Airways’ schemes for incentives to travel agents in 1999 is a rare example of such enforcement action – against a practice that, although British Airways was singled out for enforcement action, because the matter came to the Commission’s attention by reason of a complaint by Virgin Atlantic, was common among legacy airlines in Europe at the time.

One other practice that has not so far attracted attention from the Commission (except in the context of remedies in concentration and alliance cases) is the use of frequent flyer programmes. However, the Norwegian Competition Authority prohibited the use of frequent flyer programmes on Norwegian domestic routes by SAS, Braathens and Wideroe in 2002 and by all airlines in 2007, on the grounds that such programmes may have a lock-in effect on passengers which may reduce competition and raise entry barriers for new entrants. This is an area requiring a difficult balancing of the short term disbenefits to passengers of losing such schemes’ advantages against the longer term benefits of enabling smaller competitors more effectively to compete.

**Concluding comments**

The liberalisation of the internal air transport market in the EU has been a great success, and thus provides a useful example, both for other countries and regions, and for extension of the EU liberalisation beyond the borders of the EU. Perhaps the most useful general lesson that can be learnt from the EU experience is the importance of ensuring that liberalisation is accompanied by application of appropriate competition rules. However, this may be more of a challenge in an international context lacking a legal institutional framework such as exists within the EU.
End notes:

2. Council Decisions 87/601 and 87/602. See also note 6 below.
4. Council Regulations 2407/92, 2408/92 and 2409/92. These Regulations were repealed and replaced by Parliament and Council Regulation 1008/2008 on common rules for the operation of air services in the Community, OJ No. L 293/3, 31.10.2008, which consolidated them and substantially re-enacted their provisions, and is the legislation currently in force.
5. Subject to some limited exceptions with regard to cabotage over a transitional period which ended on 1 April 1997.
11. Decision 2001/716, OJ No. L265/15, 5.10.2001. The decision was upheld by the Court of First Instance on appeal.
13. The 1989 decision in which SABENA was fined €100,000 for refusing to allow its competitor London European access to its computer reservation system, and the 1992 decision in which Aer Lingus was fined €750,000 for refusing to interline with its competitor British Midland.
14. Decision 200/74, OJ No. L30/1, 4.2.2000. The decision was upheld by the Court of First Instance and the Court of Justice on appeal.
15. And three decisions, under the then equivalents of Articles 101 and 102, prior to the application of the Merger Regulation.
16. As to which, see para 89 of the Commission's guidelines on the assessment of horizontal mergers, OJ No C31, 5.2.2004. The Commission also prohibited in 2013 a proposed concentration between UPS and TNT, which, although not airlines in themselves, have significant air cargo transport operations.
21. According to the ICAO report cited above, between 1992 and 2000 the number of scheduled routes increased by nearly 75%, the number of flights by 88%, the number of seats offered more than doubled, the number of internal scheduled routes with three or more carriers increased by more than 250% and average ticket prices fell by more than 15%.
22. See Hubert Horan, Collusive Alliances and Intercontinental Competition, European Aviation Club/Airneth Seminar, Brussels, 9 December 2011 (although Horan's main argument was about the US DOT's responsibility for this).