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ANNEX TO THE SUMMARY RECORD OF THE 121st MEETING OF THE COMPETITION
COMMITTEE HELD ON 18-19 JUNE 2014

-- Executive Summary of the discussion on Airline Competition --

This executive summary by the OECD Secretariat contains the key findings from the discussion held during Item IX of the 121st meeting of the OECD Competition Committee on 18-19 June 2014.

*More documents related to this discussion can be found at
www.oecd.org/daf/competition/airlinecompetition.htm.*

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EXECUTIVE SUMMARY

*By the Secretariat**

Considering the roundtable discussion, the delegates' written contributions and the Secretariat's background note, the following key points emerge:

- (1) ***Air transportation is a vital sector for the global economy, customers and governments. Liberalisation and de-regulation have played an important role in stimulating competition. Yet, the sector remains heavily regulated and constrained by nationality conditions, thus bearing an impact on competition and market dynamics.***

There is wide recognition of the vital importance of air transportation for consumers, governments, other sectors and the global economy. Air transportation has grown over the past three decades in size, reach, demand and connectivity. At the same time, a liberalisation and de-regulation process has been undertaken in various parts of the world, with a view to introducing market dynamics and improving efficiency in the airline industry.

The role so far played by liberalisation and de-regulation should not be overstated, however. This process has not occurred everywhere and, even where it has occurred, the airline sector remains heavily regulated at national and international levels:

- At the international level, cross-border traffic rights still depend on bilateral air service agreements (ASAs), which generally include a nationality condition. This results from the Chicago Convention, which establishes that every state enjoys complete and exclusive sovereignty over the airspace above its territory. Also traffic-related services are excluded from the WTO-GATS Annex. Air transport services are thus regulated by ASAs, which often require that the airlines be owned or controlled by one of the contracting states to benefit from cross-border traffic rights. Although such a nationality condition may sometimes be justified on safety and security grounds, it creates an industry structure that limits competition and the commercial freedom of airlines. This regulatory framework explains why international airline mergers are rare and why airline alliances have developed so extensively.
- At the national level, incomplete liberalisation as well as a trend towards re-regulation can be observed. Where market distortions, inefficiencies or consumer harm arise but cannot be tackled through antitrust enforcement, governments tend to adopt corrective sector-specific rules. Recent examples include regulations addressing slot allocation regimes and airlines' loyalty programs. Government intervention raises continuing questions as to what distortions deserve further liberalisation or specific regulation and how it impacts the competitive environment in an industry that is by nature multi-jurisdictional.

* This Executive Summary does not necessarily represent the consensus view of the Competition Committee. It does, however, encapsulate key points from the discussion at the roundtable, the delegates' written submissions, and the Secretariat's background paper.

Therefore, while liberalisation and de-regulation have played an important role in stimulating efficiency and growth in the industry, airlines continue to operate under a complex and fragmented regulatory framework, which has an impact on market efficiencies and competition.

- (2) ***The airline industry is characterised by three driving trends: hybridisation of business models following low-cost carriers' entry; consolidation through the proliferation of alliances; and high exposure to financial distress and government intervention. These trends can play an important role in the competition analysis of airlines' behaviours and agreements.***

Hybridisation. Post-liberalisation entry by low-cost carriers (LCCs) has been a game changer for the air transportation industry. The low-cost carriers' no-frill and point-to-point business model has brought important benefits to consumers and has stimulated competition. At the same time, most legacy or full-service carriers (FSCs) have rationalised their activities by moving to a hub-and-spoke model, which has differentiated FSCs from short-haul and point-to-point LCCs. Today, however, numerous examples from the industry reveal an on-going phenomenon of hybridisation of business models, blurring the traditional distinction between FSCs and LCCs. This hybridisation phenomenon suggests that pure LCC and FSC models have their own limits. It also shows that airlines are able to adapt. Competition authorities may need to increasingly take hybridisation into account in their competition analysis.

Consolidation. The industry is also characterised by the emergence of alliances, airlines' most common way to consolidate their activities across borders, since nationality restrictions contained in ASAs make international mergers difficult or impossible. Alliances are often seen as the second-best option after mergers to achieve economies of density, scale and scope. Alliances vary in scope and depth, ranging from basic interlining co-operation agreements to far-reaching joint ventures. Given the number, diversity and growth of alliances, they constitute the main "phenomenon" competition authorities (sometimes other authorities, too) have had to assess as to their impact on competition and consumers.

Distress. The industry is further marked by major exits, failures, restructuring and entries. Financial distress is not new: it already characterised the industry pre-liberalisation. Whether financial distress is due to internal (e.g. mismanagement) or exogenous (e.g. oil prices) factors, it consistently raises thorny questions for governments: Should they let a carrier fail, which may be a natural consequence of competition? Or should the failing carrier be rescued given the importance of air transportation and the risk of spill-over effects on other industries? Country experiences reveal contrasting approaches. For example, major rescue or bail-out plans were adopted, and seemingly succeeded, in Japan and the US, whereas Hungary let its legacy carrier exit the market, which was soon replaced by LLCs. The EU is currently the only jurisdiction that provides a state aid law regime, prohibiting in principle state aid with a few exceptions. Beyond situations of financial distress, this opens the debate on whether it is warranted for governments to favour certain airlines, how it creates (dis-)incentives for other airlines to compete, and how it affects the playing field across jurisdictions.

- (3) ***The airline sector is marked by structural and behavioural barriers to entry and expansion that may in certain circumstances call for a regulatory or antitrust enforcement response.***

Airline competition can be subject to various types of barriers, two of which have recently attracted considerable attention from competition agencies and regulators: access to airport slots (structural barriers) and airlines' loyalty and pricing strategies (strategic barriers).

Access to take-off and landing slots at congested airports can be a key obstacle to airline competition. Most congested airports are currently found in Europe and Asia-Pacific. The issue

may deepen, since the gap between demand and airport capacity is growing, and expansion appears unlikely at most constrained airports. In various jurisdictions, legacy carriers still enjoy so-called “grand-father rights” and privileges, released only under a “use it or lose it” rule. Such a slot system creates upstream barriers to entry and expansion, harms competition and reduces efficiency. There is wide recognition of the need for pro-competitive congestion management rules and a willingness on most governments’ part to introduce market mechanisms in the slot allocation system, to ensure a more efficient use of this scarce resource. The creation of (secondary) slot markets for the sale or the lease of slots needs safeguards, however, to prevent abuses of the system by slot holders. This has led various jurisdictions to weigh (re)currently what an optimal slot allocation market system would be.

Airlines’ loyalty schemes - whether frequent flyer programs (FFPs) or corporate discount contracts – qualify as potential barriers to entry or expansion by raising the cost of switching air carrier (or switching alliance) and thus raising the cost of entry for new competitors. Experts underscore the need for competition authorities to take loyalty programs seriously: they may represent the next main threat to airline competition, by deterring entry and harming consumers eventually. Yet, competition enforcement against airlines’ loyalty schemes is rare, due to the difficulty of measuring their impact on competition and consumer welfare and, in the case of corporate contracts, of detecting them. This impact assessment is further complicated by the fact that loyalty programs can be used across airlines of the same alliance. A few competition authorities have brought cases against loyalty schemes (e.g. New Zealand). Otherwise a regulatory response may be adopted, sometimes consisting in an outright FFP ban (Norway), where there are indications of market foreclosure and/or consumer harm but no evidence of an abuse of dominance. This FFP ban allowed a low cost carrier to enter and compete in Norway against the incumbent.

For competition to be effective, customers must be able to understand and to compare prices. LCCs have introduced un-bundled offers, consisting of no-frill flights and separate ancillary services on an opt-in basis. This “à la carte” pricing strategy, which has been followed by most FCS, has increased customers’ choice and reduced prices for basic services. At the same time, un-bundled offers may be used as a strategic barrier: by un-bundling their offers, airlines can hide extra charges, mislead consumers on the actual total price, and complicate comparisons, thereby softening competition. Such partitioned or drip pricing strategies increasingly lead to actions by competition authorities (e.g. Australia and the UK) or regulatory measures (e.g. the EU) to compel airlines to provide clear and pro-competitive pricing information.

Structural and strategic barriers to entry reveal how often the airline industry triggers questions and interventions at the crossroads between competition, consumer protection and transport policies. Such barriers play an important role in the antitrust analysis of airlines’ behaviours and agreements and in the remedies imposed by competition authorities.

(4) *Delegates and experts alike agree that the evolution of the airline sector has brought significant benefits to consumers, but concerns about anti-competitive behaviours remain. Competition law enforcement plays a major role in bringing efficiencies and benefits to air transport consumers. After identifying new trends in defining relevant markets in the airline industry (4.1.), most of the discussion focused on how airline alliances and mergers are addressed by competition authorities (4.2.). The variety of these horizontal agreements subject to competition scrutiny contrasts with rare but revealing instances of abuses of dominance in the industry (4.3.).*

(4.1.) *Market definition in the air transportation is evolving. There is no consensus on the relevant markets, nor on whether enforcers should provide guidance on market definition criteria. While various competition authorities have retained the traditional origin-destination (O&D) approach, others have adopted narrower or broader definitions taking industry changes into account.*

Jurisdictions around the globe report evolving and nuanced approaches to defining the boundaries of passenger air transport markets. Various competition authorities retain the traditional origin-destination (O&D) approach, defining markets by city pairs or airport pairs, based essentially on demand-side substitutability. Differences occur as to whether markets should be further segmented between business and leisure passengers and between direct and indirect flights. On short haul flights, relevant markets have sometimes been broadened to include other means of transportation (e.g. fast trains). There is also growing recognition of the importance of taking into account network factors, although only a few countries have actually taken such factors into account in their market definition (e.g. Australia). Others would rather consider network aspects as part of the analysis of competitive effects.

There is debate as to whether more guidance on market definition should be provided. On the one hand, the business community calls for more guidance and harmonisation, to be able to assess potential competition risks arising from their conduct. Experts and most authorities, on the other hand, would rather not constrain themselves, and prefer to define markets on a case-by-case basis. The absence of guidance and a harmonised approach to market definition calls for increased co-operation among competition authorities examining the same conduct in the airline sector.

(4.2.) *Alliances are the most common horizontal agreement addressed by competition authorities, yet through different enforcement tools. The impact of network dynamics, co-ordinated effects and multi-market contact should be further considered in the competition analysis and the design of remedies. Most cases suggest that alliance competition is replacing airline competition.*

Alliances are subject to different antitrust enforcement tools and mechanisms across countries, including: (i) merger control in countries that have a broad merger definition (such as in Brazil, Canada and India); (ii) specific exemption, authorisation or immunity regimes requiring an application from the airline alliance and a case-by-case examination (such as in the US); (iii) block exemption regulations for certain types of airline alliances (such as in Israel); (iv) a self-assessment obligation to determine whether the alliance falls under an exception to cartel law (such as in the EU); and (v) residuary cartel enforcement (in most jurisdictions). All these enforcement mechanisms aim to subject alliances to antitrust scrutiny. They differ, however, as to their procedure, timing, remedies and outcome, and sometimes even as to the authority in charge. Two significant risks stem from these inconsistencies: a risk of enforcement tool shopping by airlines, and a risk of losing efficiency in competition enforcement as well as in the expected alliance benefits. This diversity makes it even more critical for competition and regulatory authorities to co-operate and for governments to consider alternatives to the ownership restrictions contained in ASAs.

From the substantive analyses of alliances around the world, the following observations emerge:

- There is seemingly wide acceptance of the potential benefits that alliances may offer. This premise leads to a consensus across most jurisdictions that alliances should not be subject to an outright *per se* prohibition, even where they involve cartel-like elements (such as sharing of sensitive information). Instead, most enforcement regimes balance out the alliance's pro-competitive and anti-competitive effects. Cartel-like concerns may be exempted, immunised or remedied in order for the alliance to proceed. This constructive approach towards authorising most alliances suggests, to some extent, a shift in competition enforcement from preserving airline competition to preserving *alliance* competition.
- Whether alliances have produced the expected benefits, and whether they benefited airlines or consumers, is strongly debated. These doubts should spark increased caution in the assessment of alliances and in the justification of exemptions and immunity treatments. The growth, diversification and complexity of alliances make competition authorities' analysis difficult, yet crucial, in ensuring consumer welfare.
- The identification of antitrust risks typically concentrates on overlapping routes. At times, more emphasis would be worthwhile on network dynamics, multi-market contacts and the risk of co-ordinated effects in the assessment of airline agreements.
- Today's main debate revolves around the appropriateness and effectiveness of remedies aimed to address antitrust concerns arising from alliances. The most common remedies consist in carve-outs (of overlapping routes) or structural divestitures (e.g. of slots). However, carve-outs may reduce efficiencies and synergies arising from the alliance, by forcing the parties to remain competitors in some markets while becoming allies in other markets. Monitoring and *ex post* evaluation of the effectiveness of remedies, together with sharing best remedy practices among authorities, could improve competition enforcement overall.

International mergers (i.e. between carriers from different countries) are rare in the airline industry, except where a complex corporate structure allows each merging airline to preserve nationality requirements, like in AirFrance-KLM and LAN-Tam. The latter case demonstrates the increased attention, in designing remedies, to competition risks stemming from network dynamics, effects on non-overlapping routes and the web of alliances in which the merging parties would operate. Domestic mergers are more common and feature a trend towards cross-model mergers, consisting often of a FSC acquiring a LCC. Such mergers prompt competition authorities to cautiously balance potential synergies from hybridisation versus the impact on consumer welfare from losing an independent low-cost provider.

(4.3.) *Enforcement against abuses of dominance is overall rare. In an industry where certain markets can inherently sustain only one carrier, further reflection is needed on how to better detect abusive conduct in the airline sector and under what economic and legal test they fall.*

Antitrust enforcement against airlines' unilateral conducts is rare. Competition authorities face various obstacles in bringing abuse of dominance or monopolisation cases: the difficulty of detecting abusive unilateral conduct in a network-based and highly regulated environment; the uncertainty around the economic and legal analysis of airlines' predatory conduct; and the complexity of designing effective remedies. It is critical, however, to address these questions, especially in the airline industry where some markets can only efficiently sustain one or a limited number of carriers. In such markets, competition authorities should carefully determine whether the absence of competition is the result of exclusionary strategies by the dominant carrier, or whether it merely reflects an unavoidable industry structure.

Predation through exclusionary pricing and selling strategies is one of the most commonly alleged abuses in the airline industry. The few enforcement decisions in the field, however, raise the question as to whether predation tests are well-suited to detect and assess airlines' predatory strategies, such as price cuts or non-price instruments:

Most jurisdictions recognise the potentially harmful effects of predatory pricing, but there is no consensus on the legal test or relevant cost benchmark. Particularly in the airline sector, whether low prices were effectively below-cost may not be conclusive due to the complex cost structure of airlines. Whether recoupment is a relevant criterion is also questioned in such a multi-market context. The few enforcement decisions against predatory pricing in the industry (e.g. in Germany) would focus on whether the airline's pricing strategy could have any objective justification besides deterring entry or excluding competition (notably by a low-cost competitor).

Predation may also take the form of capacity dumping: an airline may drive rivals out of a specific market by increasing airplanes' size and/or the number of flights. Such a strategy may not amount to below-cost pricing, but it can sacrifice profits for exclusionary purposes. An enforcement example from the US shows that courts and competition authorities may disagree on the right test to assess capacity increases and profit sacrifice, and on how to establish what economic conditions would prevail "but for" an exclusionary strategy.

Another type of exclusionary conduct that has emerged in the airline industry is exclusion through loyalty schemes. Although antitrust cases of this nature have so far been rare (e.g. Sweden), air transportation experts warn that loyalty schemes could be the next major challenge for competition enforcers.

Designing effective remedies to address airlines' abusive conducts are another challenge for competition enforcers. In predatory pricing matters, remedies have consisted in imposing pricing above certain levels, based on e.g. the airline's own cost structure or competitors' prices. In capacity dumping matters, remedies could consist in allowing the incumbent to add capacity or frequency in response to competitor entry only when there is a reasonably foreseen profit. In loyalty scheme abuses, remedies may consist e.g. in an outright ban or in carving out certain routes from the loyalty scheme, on which entry is deterred by the abusive scheme.