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AIRLINE COMPETITION

-- Expert Paper by Pablo Mendes De Leon --

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*More documents related to this discussion can be found at
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COMPETITION IN INTERNATIONAL MARKETS: A COMPARATIVE ANALYSIS

Executive Summary

This report concisely addresses competition in international air transport markets. It starts with a discussion of airline behaviour which is liable to be subjected to a competition law regime, and analyses why competition in the market behaviour in the air transport sector is a complex subject as the prevailing regulatory regime does not favour and, indeed, sometimes creates immunity from the application of competition law regimes.

This traditional regime is now affected by the increasing tendency to apply competition law regimes to the operation of air services, to begin with in the US and the EU. The experiences in those jurisdictions are described in other reports. This report attempts to signal topical developments in this field by highlighting the development from traditional bilateral air services agreements to Open Skies agreements, the introduction of competition principles on services from and to points in the EU, and the establishment of and experience with competition law and case law made in other parts of the world, that is, Latin America, Asia and Africa.

It is concluded that the application of competition law provisions raises myriad questions as to competencies, applicable rules, relationship with the above traditional regime governing the operation of international air services and jurisdiction. For the time being, cooperation between competition authorities and the application of the 'effects' doctrine should fill jurisdictional gaps. While the International Civil Aviation Organization (ICAO) is studying the matter of 'fair competition' it appears that its member States are not yet ready for convergence or harmonisation of competition law regimes, nor for the formulation of a global competition regime which would be useful and desirable for a cross border activity like air transport.

While State subsidies are not addressed in this paper, it is submitted that air transport is the only economic activity which is not subject to the WTO/GATS regime, for reasons which are related to the above circumstances pertaining to policy and law governing airlines and the operations of their services. However, lessons can be learned from this regime to remedy at least certain anti-competitive practices including the imposition of measures on subsidies, dumping and predation, and experiences with institutional mechanisms.

As competition in international market has traditionally been regulated under restrictive bilateral air services agreements supervised by the States party to them, and international air transport markets are only gradually opening up and allowing for 'fair competition', this report is more 'regime' than 'case' oriented. Indeed, anticompetitive behaviour in the airline industry in international markets has not often been made subject to enforcement actions carried out by competition authorities.

1. Airline behaviour affecting competition

1. Airline behaviour may affect competition. This section looks principally at behaviour in international markets which are often governed by bilateral air services agreements.

2. Undertakings, including airlines, can engage into two principal activities which may negatively impact competition. They are:

a) *Co-operative agreements*, designed to achieve air service efficiencies, are widespread among airlines; they form an essential part of airline operations and are used as an instrument of cost reduction and risk spreading. Co-operation between airlines includes:

- consultation on and co-ordination of tariffs, within or outside the International Air Transport Association (IATA);
- joint operations, including pooling of services and capacity;
- interline agreements providing for the establishment of a single fare for a through service provided by two or more different airlines;
- route planning and co-ordination of schedules between airlines;
- fleet rationalisation, including arrangements on code sharing, franchising and blocked space agreements economising capacity for the participating airlines;
- joint frequent flyer programs (FFPs) allowing passengers access to the FFP's of different airlines mostly in the context of an airline alliance;
- Airport scheduling and slot allocation permitting airlines to arrange arrivals and departures at airports at the most convenient times.

3. Cases coming under EU law will be discussed by John Balfour in his paper entitled: "Airline liberalisation and competition: The EU Experience". International case law, that is, the *air freight cartel* cases, will be discussed below (in 4.5).

b) *Abuse of dominant position*

- Notably 'flag carriers' inherited dominant positions from the traditional regulatory and policy regime which will be discussed below. Dominance may lead to abuse, that is, monopolisation and predatory behaviour. Predatory behaviour may occur in the areas of market access, including refusal to interline by a dominant carrier with another carrier, predatory pricing, capacity (dumping), and limitations of access to Global Distributions Systems dominated by an airline or airlines belonging to an alliance. Currently, EU airlines are closely watching the actions undertaken by especially Middle East airlines on routes to and from points in the EU on which they try to, or are accused of trying to achieve dominance. In this context, arguments on predatory pricing and capacity dumping are being heard. However, these concerns have not yet led to competition cases, among others because the bilateral regime governs these services and dictates remedies for such concerns. The question of State aid which is forbidden by EU law but not by other jurisdictions is also raised in this context as to which see further below.

2. The strain between the competition and international air transport regime

4. A number of the above concerted and unilateral activities are mandated by bilateral air services agreements. At the same time, they may be forbidden under competition law regimes, in particular that of the EU which proceeds from an ‘open market economy with free competition’ (Art. 119 of the Treaty on the Functioning of the EU, also referred to as TFEU).

5. Under bilateral air services agreements, the operation of air services were, and in some areas are still seen as the operation of a *public service* which should not be left to market principles as national, or ‘flag’ carriers such as Olympic Airways, Air France, Air India, Aeromexico, Japan Airlines and many others had to be shielded from competition. Their survival was and still is deemed to be essential for the trade and economy of the States which designated them to operate the agreed international air services. In order to achieve the mentioned policy objectives, the amount of traffic, pricing and other features of the operation of air services was predetermined by States parties to such agreements, and, in other instances, reviewed *ex post facto* by them on the basis of Origin and Destination (O/D) traffic statistics. Clearly, these concepts of ‘predestination’ and division of market shares cause incompatibilities with competition law regimes as those proceed from an open market in which services and goods can be freely offered and sold, and which market is regulated by – *ex post facto* – competition rules. This tension is explained by the ICAO Secretariat in the following statement:

“Furthermore, the traditional approach in many bilateral agreements favouring airline cooperation on issues like capacity and pricing is squarely at odds with competition laws that strictly prohibit price fixing, market division and other collusive practices by market competitors.”¹

6. Hence, competition authorities had to, and have taken the above international air transport regime into account when judging air transport cases. For instance, the EU Commission reduced the fines on the colluding airlines by 15 % in the *Airfreight cartel* case because of the existence of the “general regulatory environment.”² In their appeal procedures, a number of EU and non-EU airlines argue that the allegedly illegal conduct “was supervised and effectively required by government agencies.”³

3. From traditional bilateral air services agreements to Open Skies agreements

7. Following the deregulation of the US domestic markets since 1978, and the EU liberalisation process which started in 1987, as described in the above (see 1.2) paper drawn up by John Balfour, the US introduced its market oriented approach towards the operation of international air services in its ‘Open Skies’ policies which the conclusion of ‘Open Skies’ agreements.⁴ The first one was concluded with the Netherlands (in 1992); currently, there are about 150 Open Skies agreements, not only between the US and its aviation partners but also between other States such as the UK and Singapore.

8. The most well-known ‘Open Skies’ agreement is the EU-US Agreement on air transport concluded in 2007 and amended in 2009 (the Agreement). Competition matters should be dealt with in mutual understanding reached through consultations between the EU Commission and the US Department of Justice and Department of Transportation (DOT). Annex 2 of this Agreement details areas of

¹ ATConf/6-WP/4 at 4.4

² Case COMP/39258, EU Commission Decision of 11 September 2010 (*unpublished*)

³ See, Cases T-43/11, *Singapore Airlines and Singapore Airlines Cargo v. Commission*, and Case T-46/11 *Deutsche Lufthansa v. EU Commission*

⁴ For the US side, see the paper from Severin Bornstein

cooperation and procedures for cooperation. The three global alliances - OneWorld, Skyteam and Star - have been judged by concerted action between the said authorities. The same is true for the mergers affecting the relevant market of the other party; reference is made to for instance, the merger between Air France and KLM in 2003 in which the DOT approved it the day after the approval made by the EU Commission. No reference was made to the ‘positive comity’ principle and the procedure drawn up in the 1991 EC-US Cooperation Agreement on Cooperation matters regarding competition and the 1998 ‘Positive Comity Agreement’ explaining and implementing this principle.

9. Whereas *market access* in terms of compliance with safety and security requirements, nationality restrictions as laid down in conditions pertaining to ‘substantial ownership and effective control’ of the airlines to be designated, prohibition (EU) or allowance (US, in certain circumstances) of State aid, and infrastructural (slots) and environmental (lack of capacity because of noise limitations) constraints are regulated by States in bilateral, plurilateral (as to which see 3.2 concerning the EU-US Agreement on air transport) or local (for infrastructural) arrangements, market behaviour (see 1.1) is now subject to competition rules. As air transport in the current scenario is a cross border activity, and absent a global competition regime, the question is which competition rules, and which authorities are mandated to enforce them. The following section will concisely present the management of competition on external EU routes.

4. The management of competition on external EU air services

10. The EU Competition rules on market behaviour, including prohibitions on concerted actions (Art. 101 TFEU) and abuses on dominant provision (Art. 102 TFEU) are implemented in EU Regulation 1/2003, which has been amended by EU Regulation 411/2004 bringing the operation of international air services under the scope of EU Regulation 1/2003. EU Regulation 487/2009 allows the EU Commission to exempt specified categories of agreements, including but not limited to coordination of schedules, tariff consultations, and concerted practices as to slot allocation and airport scheduling, and the common purchase, development and operation of Global Distribution Systems (GDS) from the scope of competition law. So far the EU Commission has not made use of this power so that EU Regulation 1/2003 applies in full to the operation of air services, whether intra-EU or between points in the EU and outside the EU.

11. Summarising, in order for the EU Commission, and other competition authorities around the world, three principal questions have to be tackled:

- i. The relationship with the prevailing regulatory framework, that is, principally, bilateral air services agreements restricting market entry and, as the case may be, market behaviour;
- ii. Overlapping jurisdictional competencies of competition authorities in cross border markets;
- iii. Overlapping rules regulating competition in cross border markets.

12. Absent global understanding on the subject, these questions are addressed by the following measures:

- A. Guidance from ICAO (International Civil Aviation Organization) on ‘*fair competition*’, including proposals for ‘fair competition clauses in bilateral air services agreements’;
- B. *Agreements between competition authorities on cooperation* so as to avoid duplication of efforts, such as the 1991 EC-US Cooperation Agreement on Cooperation matters regarding competition of 1991 (as formalised in 1995), the ‘Positive Comity Agreement’ of 1998 explaining and implementing this principle, and the procedures laid down in the “EC-Canada agreement regarding the Application of their Competition Laws” (1999).

- C. The application of the ‘*effects*’ doctrine which also originates in the US.⁵ Ever since the adoption of this concept in the *Alcoa* case, States have enacted it in their national competition legislations or other arrangements. They include but are not limited to Brazil, India, South Africa, Japan (via an Agreement with the EU), Korea (through international agreements) and China in relation to its Anti-Monopoly Act but not yet for other competitive behaviour. This doctrine has also been applied in the air transport sector as evidenced by the above *Airfreight Cartel* cases as to which see the next section.

4.1 *Airfreight Cartel cases*

13. EU and non-EU airlines, that is, Air Canada, Air France-KLM, British Airways, Cathay Pacific, Cargolux, Japan Airlines, LAN Chile, Lufthansa and Swiss, Martinair, SAS, Swiss, Singapore Airlines and Qantas were said to have operated a worldwide cartel influencing the pricing of air cargo services by the commonly agreed introduction of surcharges for the operation of air cargo services. In 2006, the EU Commission carried out dawn raids in the head offices of the concerned airlines. Ten out of eleven airlines including principally Lufthansa were given reductions for cooperation under the Commission’s Leniency Programme.⁶ Moreover, all carriers received a reduction of 15 % “on account of the general regulatory environment in the sector which can be seen as encouraging price coordination.”

14. As explained above, the bilateral framework and the former role of IATA with respect to coordinating of tariffs and rates helped to create not only inter-government but also inter-airline discussions. On 9 November 2010 the EU Commission imposed fines on eleven airlines to a total amount of nearly 800 million € for operating a world-wide cartel in the air cargo market. The Commission found that the arrangements infringed Article 101 TFEU (see above).⁷ All airlines apart from Qantas airlines appealed from the decision.

15. The appealing airlines claim that:

- the level of the fines is disproportional to the low profitability of the airline sector;
- the EU Commission’s decision infringes the principle of equal treatment in applying different standards of proof;
- the decision fails to correctly define the *relevant market*, and that:
- it violates the principles of non-interference or comity between States;

⁵ The doctrine found its origins in a US antitrust case called the *ALCOA* case; *United States v. Aluminum Co. of America*, 148 F.2d 416 (2d. Cir. 1945). Not surprisingly, this doctrine has also been relied on in an aviation case, to wit the *Laker Airways* case (731 F.2d at 925). Under it, US antitrust laws may be applied whenever anticompetitive behaviour conducted abroad is intended to, and results in substantial effects in the US. The then ECJ has adopted the concept in, among others, the *Wood Pulp* cases; Cases 89/85, 114/85, 116-117/85, 125-129/85, *A. Ahlström Osakeyhtiö v. Commission (Wood Pulp)*; Decision of the ECJ of 27 September 1988. The Court stated that the conclusion of the agreement in question “has had the effect of restricting competition within the Common Market.”

⁶ Current version: see Commission’s Notice on *Immunity from fines and reduction of fines in cartel cases*, Official Journal of the European Union C 298/17-23 (2006)

⁷ Case COMP/39258 – *Airfreight* decision of 9 November 2010; IP/10/1487

- the EU Commission excessively exercises its jurisdiction with respect to activities regulated and managed outside the EU jurisdiction (see the previous section on the ‘effects’ doctrine);
- The decision infringes the principle of proportionality by reducing the fines by 15 % only on account of the prevailing principles of cooperation in the established regulatory framework.

16. In this case, the airlines involved in the airfreight cartel tried to refer to the regulatory environment which is not, or not only made up by national and international law, but also by EU law. Indeed, in the past, cargo tariff consultations “benefited from a block exemption under Commission Regulation 1617/93, which effectively enabled European airlines to agree on tariffs for the carriage of freight.”⁸ However, those block exemptions are not in place anymore. A number of airlines also relied on the ‘public regulation’ defence in their appeal procedures contesting the legality of the EU Commission decisions of 2010.

17. The judgements of the General Court of the EU are expected for 2015 at the earliest.

18. In short, competition authorities are trying to cope with the patchwork of regimes in the most efficient fashion, taking into account the global nature of air transport. While ICAO is making proposals for a more unified approach towards the subject, it is unlikely that these proposals will yield concrete results in the near future as States do not want to give up jurisdictional powers and no consensus yet appears to emerge regarding the application of competition laws to the operation of international air services as set out in section 1.2 above.

5. Competition regimes in various parts of the world

5.1 *The EU-Morocco Agreement (2006)*

Competition in the EU-Morocco Agreement is governed by Chapter IV of the EC-Morocco Association Agreement which dictates that the EU competition rules must be applied to the trade of goods and services between the EU and Morocco. Special rules apply to State subsidised enterprises under the EU-Morocco agreement on air transport as State subsidies for airlines are not forbidden *per se* but the Contracting Party under whose jurisdiction a State subsidised airlines falls must demonstrate that such subsidies are “proportionate to the objective, transparent and designed to minimise their adverse effect to the carriers of the other Party.”

5.2 *The EU-Israel Agreement (2013)*

19. This Agreement refers to ‘fair competition’ as an objective of the Parties, whereas it prescribes that questions on subsidies affecting the ‘fair and equal opportunity to compete’ principles must be made subject to consultations between the parties, or to the attention of the Joint Committee. Failure to do so entitles the other party to refuse and suspend the operating authorisations of the subsidised carrier, as long as these remedies are proportionate and restricted with regard to scope and duration to what is strictly necessary.

5.3 *Horizontal Agreements between the EU and certain third States*

20. Horizontal Agreements (HA) are **negotiated by the Commission on behalf of EU Member States, in order to bring existing bilateral air services agreements between EU Member States and a**

⁸ See, EU Commission, Press Release IP/01/694 dated 15 May 2001, Commission takes preliminary view that IATA cargo tariff consultations infringe competition rules

third country in line with EU law, in particular EU law on the freedom of establishment. Some of these agreements contain a clause governing competition.

21. An example of such a HA is the one concluded between the - then - EC and the United Arab Emirates (UAE) on 'certain aspects of air services' on 30 November 2007. The Preamble of this agreement specifies that it is not designed to increase the total volume of air traffic between the EU and the UAE, or to affect the balance between EU air carriers and UAE air carriers, or to prevail over the interpretation of existing provisions of air services agreements between EU States and the UAE.

22. The agreement dictates that behaviour of designated airlines should be compatible with competition rules as laid down in there (Art. 6). Prohibited behaviour regards:

- i. the adoption of agreements between undertakings, decisions adopted by associations of undertakings or concerted practices that prevent or distort competition;
- ii. reinforcement of the effect of any such agreement, decision or concerted practice;
- iii. Delegation to private economic operators the responsibility of engaging in such anti-competitive practices.

23. The agreement does not forbid the abuse of a dominant position, and does not address State aid. Even more importantly, there are no enforcement provisions; hence we assume that this is left to the competent aeronautical authorities of the EU States listed in the Annex and those of the UAE. As far as we know and can see this provision - on competition - has not been applied or enforced.

5.4 Latin America

24. Latin America knows a few regional organisations which aim at contributing to the liberalisation of air services on a regional level. They include the Andean Community⁹ and the Andean Pact in the 'Andean' region which does not know a supranational completion authority, the Mercosur Agreement which is signed by Argentina, Bolivia, Brazil, Paraguay and Uruguay, and the Association of Caribbean States (ACS). Of these, the Mercosur Agreement is the only one referring to the elimination of unfair competition practices, without establishment of substantive criteria for that notion ('fair competition'), procedures or a regional competition authority.

25. Inspired thereto be ICAO, the Latin America Civil Aviation Conference (LACAC)¹⁰ has drawn up a model clause to be inserted in air services agreements between States members of LACAC. This clause intends to prevent unlawful and anti-competitive behaviour by airlines, including excessive capacity and predatory pricing, without the introduction of procedures, remedies and the grant of competencies to competition authorities. LACAC also promotes an Open Skies agreement among its Member States.

26. Five Latin American States that is, Columbia, Chile, Peru, Brazil and Argentina have concluded Open Skies agreements with the US whereas air services between Argentina and Uruguay are operated on a fairly liberal manner. However, this is not to say that they make room for the application of a competition law regime or for the supervision thereof by a competition authority.

⁹ Member States are Bolivia, Columbia, Ecuador and Peru

¹⁰ Involving most Latin American States whereas the States with the largest markets, namely Brazil and Columbia, do not implement or apply this clause.

27. The Agreement of 2011 between the EU, its member States and Brazil dictates that the competition laws of each party shall apply to the operation of the agreed services, whereas the parties “share the objective of compatibility and convergence of competition law and will cooperate as appropriate and when relevant on the application of competition law.”¹¹ Reportedly, competitive concerns in relation to market dominance by EU air carriers are raised on the Brazilian side: Brazilian carriers are said to be worried about the dominance of the EU carriers on the EU-Brazil market which concerns should dissuade their authorities from ratifying this agreement. Effectively, the said operations are still governed by the prevailing bilateral regimes between Brazil and EU States.

28. Case law is available on a national level. For instance, the LAN (Chile) –TAN (Brazil) merger has been judged by Chilean and Brazilian competition authorities, and by the Civil Aviation Authorities of these countries.¹²

5.5 *Asia: ASEAN*

29. In Asia, the most important regional organisation targeting the liberalisation of air traffic is the Association of South East Nations (ASEAN) under whose auspices a *Multilateral Agreement on Air Services* (MAAS) has been formulated. The principal purpose of this agreement pertains to the relaxation of restrictions on the operation of traffic rights in the region, which are, however, still governed by bilateral air services agreements between the ASEAN States.

30. The MAAS lists a number of anti-competitive practices including predatory pricing. It does not know a mechanism to combat anti-competitive practices.

31. This is not to say that ‘traditional’ airlines can easily keep their market positions. Low cost carriers are picking up increasing market shares; for instance, Air Asia is setting up daughter companies in various East and South Asian States which raises market access and licensing questions in those countries. In the absence of experience with the application of competition law regimes to the operation of air services in a market oriented environment, the Civil Aviation Authorities of ASEAN States have to approve such applications on the basis of, among other, national ownership and effective control criteria.

5.6 *Africa*

32. Liberalisation of air transport in Africa was meant to be redressed by the Yamoussoukro Decision (YD) of 1991, liberalising air transport on the whole continent. The YD has been formalised in 2002, when it received binding force, and includes the introduction of ‘fair competition’ principles and the application of competition rules.¹³

¹¹ See Art. 15 of the EU-Brazil Agreement of 2011

¹² The merger between Avianca (Columbia) with TACA (a multinational airline from El Salvador, Costa Rica and Peru), and COPA with Aerorepública have been judged by the Columbian authorities.

¹³ The YD includes a provision encouraging States to “... ensure fair opportunity on non-discriminatory basis for the designated African airline, to effectively compete in providing air transport services within their respective territory.” (cf. Art. 7). The YD does not explain how to ‘effectively compete’ as it does not contain provisions forbidding cartel like agreements between airlines, abuse of dominant positions or state aid. Art. 9(5) states that the executive agency should possess “sufficient powers to formulate and enforce appropriate rules and regulations that give fair and equal opportunities to all players and promote healthy competition.” Hence, whereas Art. 7 are designed to promote ‘effective competition’, Art. 9(5) foster ‘effective competition’. Said terms are not defined.

33. While the results on a continental level are not impressive,¹⁴ progress has been made on the regional and sub-regional level as realistically facilitated by the YD and exemplified by East African Community (EAC), the Common market for East South Africa (COMESA) and the South African Development Community (SADC). These organisations have overlapping memberships whereas bilateral air services agreements are still the dominant in the field of market access. Relationships between sub-regional groupings and between those sub regional regimes and the bilateral regime are not always clear.

34. All of the above African regional organisations have a mandate for the establishment of a competition law regime whose provisions, procedures and remedies are based on EU or US standards and a competition authority. They have succeeded to create them in supranational regulations but as far as we know their involvement with the examination of cases is limited or even absent.

35. Reportedly, each of these organisations and the three of them discuss how to combine their efforts, especially with the purpose of establishing a Joint Competition Regime and a Joint Competition Authority on Air Transportation Liberalisation (JCA). The three organisations are discussing how to draw up an Air Services Agreement (ASA) template for the implementation of the YD provisions in the tripartite region, and an institutional mechanism to assure oversight of joint implementation.

6. Concluding remarks

36. Bilateral provisions may stand in the way of enforcing competition rules. This tension forms one of the challenges which the present study attempts to address.

37. Airline behaviour may affect competitive conditions in the marketplace. The market is governed by bilateral air services agreements limiting competition between the designated airlines under those agreements in a more - that is, the traditional ones - or less - that is, the Open Skies models - articulated fashion by the applications of provisions controlling competition.

38. This paper also identifies regional plurilateral (e.g., the EU-US market) efforts to introduce a competition law regime, which is applied by competition authorities based in the jurisdiction which is affected by the claimed anti-competitive behavior.

39. In view of the cross border nature of fair transport, and the absence of converged or harmonised competition regimes, solutions for jurisdictional gaps must for the time being formed by the application of the 'effects' doctrine and cooperation between competitive authorities. The US and EU are setting the scene in these respect. More understanding of and respect for each other's rules and procedures would effectively enhance convergence and perhaps even harmonisation. The OECD's efforts to contribute to the achievement of those objects should be highly praised.

¹⁴ For an extensive analysis of the Yamoussoukro Decision, see Charles E. Schlumberger, *Open Skies for Africa*, Implementing the Yamoussoukro Decision 9-60 (2010)