

REMEDIES IN AIRLINE MERGER CONTROL – THE EUROPEAN EXPERIENCE

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ABSTRACT

According to European merger control regulation, a merger which leads to substantial impediments to competition might be prohibited, or competition authorities might apply remedies to prevent market dominance. Most transnational airline mergers in Europe became subject to such remedies. In particular, merging airlines are obliged to surrender slots at congested airports to new entrants or expanding competitors. In this paper, first the potential competitive effects of airline mergers on city-pair markets are discussed. Second, the remedies imposed by the European Commission are analyzed from a theoretical perspective. The empirical assessment of developments on city-pair markets subject to remedies shows the limited success of the measures taken by the European Commission. Finally, the paper discusses options for future merger control in the European air transport industry.

KEYWORDS

Airline merger control, airline competition, airport slots, competition policy

1. INTRODUCTION

Until the full deregulation of the market for international air transport within the European Community in 1993, restrictive bilateral Air Service Agreements (ASA) protected the mostly state owned national carriers from competition on intra-European routes. Usually, city-pair markets between two European countries were equally divided between their respective ‘flag carriers’. After the deregulation of the intra-European market, new entrants concentrated on smaller airports, especially due to capacity constraints on hubs dominated by the incumbents. Nowadays, low-cost carriers (LCC) like UK-based easyJet serve many traditional hub airports, e.g. Amsterdam, Rome and Madrid, also operating seventh freedom flights within the EU. However, for city-pair markets involving capacity constrained hubs like Frankfurt, Paris, and London-Heathrow, a duopoly of two former flag carriers is still a widespread market structure. Therefore, even in today’s deregulated European airline market, some patterns of the traditional regulated environment have survived.

Compared to the US, the European air transport market is rather fragmented. Especially airlines from small and mid-sized countries face several challenges, including small home markets, growing competition from new entrants, and high cost levels, to some extent still resulting from the pre-deregulation and pre-privatization period. Industry observers therefore expect a further consolidation of the European airline industry (Holloway 2008, p. 42). Although the European Commission (EC) tries to prevent competitive distortions caused by state aid ‘flag carriers’ still enjoy a preferred treatment in some EU member states. For example, government intervention prevented the market exit of loss-making carriers like Alitalia in Italy (Beria et al. 2011) and Olympic in Greece.

For many years, nationality clauses in bilateral Air Service Agreements with countries outside the EU were a significant obstacle for transnational mergers. However, the growing number of ‘Open Skies Agreements’ between the EU and other countries, especially the opening of the transatlantic market, has to a large extent removed this barrier to consolidation (Fichert, Hüschele 2008).

During the last decade, several transnational mergers between European airlines have taken place. Since the airline industry is subject to the general provisions of European competition policy, mergers with an impact on the internal market are assessed by the European Commission's Directorate General Competition (DG COMP). In order to prevent significant impediments to effective competition, especially the formation or strengthening of a dominant market position, the EC can impose remedies on the merging firms or even prohibit the entire merger.

In this paper, the legal remedies imposed by the EC on merging airlines are analyzed from an economic perspective. The remainder of the paper is organized as follows. In section 2 the potential impediments on competition caused by airline mergers are discussed. Section 3 gives an overview on airline mergers in Europe and the EC's decisions. In addition, it is discussed whether the design of the remedies has changed over the last years. In section 4 the outcome of these remedies is analyzed and factors influencing their success are discussed. Section 5 draws some conclusions.

2. POTENTIAL EFFECTS OF AIRLINE MERGERS

2.1 Overview

From a management perspective, mergers between airlines show different types of advantages. First, unit costs might be reduced, e.g. by joint procurement or the centralization of departments like IT or marketing. Second, within the merged airline the route network can be better adapted to consumer's preferences, especially leading to reduced total travel time (product improvement). Already for strategic airline alliances enabling 'seamless travel' is an important issue. Within a merged entity, obstacles to adapt schedules are likely to be smaller than within an alliance of independent firms. In general, these advantages are also recognized by competition authorities. Furthermore, if both airlines hold monopoly positions on different city-pairs markets which are also used by a large number of transfer passengers (e.g. feeder services), the merger may not only lead to a higher quality of the airline product but also to reduced fares by eliminating the double marginalization effect.

Nevertheless, horizontal mergers always reduce the number of competitors in the market. If barriers to entry are significant and the combined market share of the merging airlines exceeds a critical threshold, competition will be constrained, leading to welfare losses and harming consumers.

2.2 Impediments on competition caused by airline mergers

For competition authorities, market delineation is a crucial precondition for the assessment of competitive effects caused by mergers. In general, markets for scheduled airline services are analyzed on a city-pair level. For some mergers it has to be taken into account whether neighbouring airports are serving the same passenger market (e.g. in the case of London) and if high-speed trains can be considered as a close substitute to air transport services (intermodal competition). This paper concentrates on intra-European markets. Therefore the analysis can be limited to direct services. On long-haul markets also transfer services have to be considered as a substitute.

Depending on the pre-merger market structure, several options for anti-competitive effects of an airline merger exist. In case of a duopoly, a merger will inevitably result in a monopolistic market structure. Since most competitive intra-European markets are only served by two airlines (European Commission 2011, p. 103), this problem arises with almost all transnational mergers. If prior to the merger more than two airlines serve a city-pair market, the competitive effect depends on the market share of the two merging partners compared to the market share(s) of the remaining competitor(s). However, in some cases the merging airlines claim that without the merger, one of the merging airlines would have ceased its operations ('counterfactual'), thereby arguing that the merger is not the determining factor for market concentration.

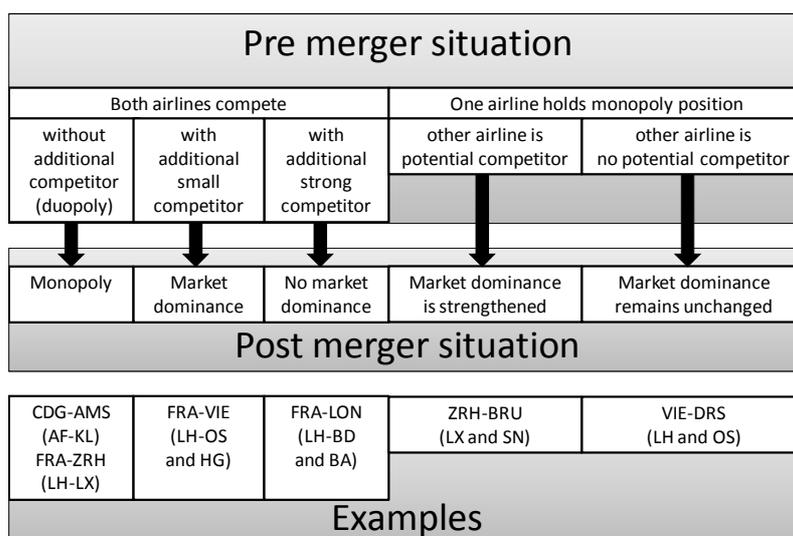


Figure 1. Competitive effects of mergers on city-pair markets

In a monopoly market, a strengthening of the incumbent's position might occur if the other airline is considered to be a potential competitor. Many city-pair markets have a low passenger volume, allowing only one airline to operate. However, those 'thin' markets are often characterized by low barriers to entry (e.g. services between two secondary airports) and therefore do not cause competitive concerns. Figure 1 summarizes the different options and assigns examples from recent European mergers.

3. AIRLINE MERGERS IN EUROPE

3.1 Overview

Since 2004, the year in which an extensive reform of the EU merger guidelines came into effect, the EC examined eleven mergers among European airlines. If the effects of a merger are to a large degree limited to one EU member state, national competition authorities remain responsible for merger control (e.g. the German competition authority decided on two mergers between Air Berlin and the German airlines LTU and TUIfly, respectively). Table 1 provides an overview of the decisions of the EC since 2004 dealing with mergers among European airlines.

Table 1. Overview of EC's airline merger decisions since 2004 (European carriers only)

Merger approved	Merger subject to conditions	Merger prohibited
KLM-Martinair (2008)	Air France-KLM (2004)	Ryanair-Aer Lingus (2007)
Lufthansa-bmi (2009)	Lufthansa-Swiss (2005)	Olympic-Aegean (2011)
British Airways-Iberia (2010)	Lufthansa-Eurowings (2005)	
	Lufthansa-SN Brussels (2008)	
	Iberia-Vueling-Clickair (2009)	
	Lufthansa-Austrian Airlines (2009)	

In two of the three mergers which were approved without remedies one merging airline originates from the UK. This already indicates that international air transport markets in the UK in general are less concentrated than markets in continental Europe. On markets between the UK and Germany, BA is a strong competitor for Lufthansa-bmi, whereas on markets between the UK and Spain, especially easyJet (but also Air Europa and Ryanair in the London-Madrid market) hold significant market shares. The case of KLM and Martinair is special, since Martinair's passenger services are confined to long-haul leisure markets.

The two prohibited mergers would have led to dominant positions on many origin and destination (O&D) markets since the two airlines intending to merge both operate a large number of flights out of their common home market (Ireland and Greece, respectively).

3.2 Remedies imposed by the European Commission

If an airline merger increases efficiency, parts of the benefits associated with the merger are passed on to consumers, but on some markets significant impediments to competition are likely to occur, remedies are used by competition authorities in order to remove those detrimental effects without prohibiting the entire merger. The remedies aim at strengthening smaller competitors (if existing), encouraging potential newcomers by reducing barriers to entry, and preventing incumbents from re-monopolizing the market. Table 2 summarizes remedies imposed by competition authorities in Europe and relates them to the respective barriers to entry.

The transfer of slots to newcomers or smaller competitors is an absolute condition to revitalize competition on city-pair markets involving one or even two congested airports where the ‘grandfathering’ of slots prevents market entry. Several organizational issues have to be determined, including the number of slots to be transferred, the maximum time span between the slot time requested by the competitor and the slot surrendered by the merged airline (‘bracket period’), and the use of transferred slots in case of the newcomer’s market exit.

There is only limited information publicly available on the EC’s criteria for determining the number of slots to be surrendered. On short-haul flights, at least two daily slots have to be transferred in order to allow same day return trips which are crucial for high yield business passengers. Moreover, with an increasing number of O&D-passengers, the number of transferred slots should grow allowing the competitor to achieve a sufficient market share and impose competitive pressure on the merged airline. In the case of Lufthansa and SN Brussels, the European Commission based the number of slots to be surrendered to competitors on the number of daily frequencies offered by SN Brussels prior to the merger (European Commission 2009, para 450). This rather formal rule led to some inconsistencies. On the Brussels-Hamburg market with approximately 125,000 passengers in 2008 (100,000 of them O&D) up to three slots would have to be transferred to a newcomer, whereas on the Brussels-Frankfurt market (approximately 450,000 passengers in 2008; 140,000 of them O&D) only two slots would have to be surrendered by the merged entity. If the merging airlines previously already cooperate on city-pair markets, the number of slots to be surrendered is not determined by the pre-merger market structure but by other criteria.

Table 2. Barriers to entry and related remedies

Barrier to entry	Related remedies
Capacity constraints at (hub) airports	Transfer of slots to new entrant or existing competitor
High frequency of service by incumbent	Obligation to interline and/or code share (if requested)
Incumbent’s frequent flyer program (FFP)	Obligation to open FFP to competitor (if requested)
Danger of predatory behavior - Capacity increases - Predatory pricing	- ‘Frequency freeze’ after market entry - Obligation to reduce fares also on monopoly markets
Restrictive ASA (only long haul)	Permission of fifth freedom services

In all transnational mergers, the obligation to surrender slots covered several city-pairs markets between the home countries of the merging airlines. Moreover, due to airline alliances and minority share-holdings, markets to other countries were also affected. For example, because of the tight link between Air France and Alitalia, remedies in the Air France-KLM merger were imposed for city-pair markets between the Netherlands and Italy. In the AF-KL and the LH-LX cases, legal measures also covered long-haul markets where one airline’s transfer services were considered to be close substitutes for the other airline’s nonstop services.

Since not all remedies turned out to be effective (see section 4), some tightening of the conditions occurred. Especially the ‘grandfathering’ of transferred slots was made easier in more recent decisions, providing additional incentives for entering the market (Bonova et al. 2009). Moreover, the institutional framework was changed to improve the legal position of the competitor (e.g. quicker decisions, better monitoring).

The grandfathering of slots at congested airports provides some incentives for the incumbent to regain his monopoly position after market entry has occurred (Fichert 2002). Hence, remedies also aim at preventing predatory behavior. In order to avoid ‘capacity dumping’ after the market entry of a newcomer, the European Commission imposed a ‘frequency freeze’ in some of the older cases (Lufthansa-Eurowings, Lufthansa-Swiss, and Air France-KLM), limiting the number of daily frequencies after a newcomer has entered the market. In the Air France-KLM and the Lufthansa-Swiss merger, another obligation refers to the airline’s pricing policy. If the merged airline reduces its fares after the entry of a newcomer on a former monopoly route (in the Air France-KLM merger, this obligation only refers to the Paris-Amsterdam market), it also has to reduce its fare on one other city-pair market where it is still holding a monopoly position. Neither the ‘frequency freeze’ nor the obligation for reducing fares has been applied in the more recent decisions, despite the fact that in at least one case (Lufthansa-Austrian Airlines) one potential competitor recommended such measures.

4. ASSESSMENT OF REMEDIES IN EUROPEAN AIRLINE MERGER CONTROL

Table 3 provides an overview of developments on intra-European city-pair markets subject to remedies. In the Air France-KLM as well as in the Lufthansa-Swiss merger, additional remedies were imposed for some long-haul markets, which are not analyzed in this paper.

Successful market entry can only be observed in a small number of formerly monopolized city-pair markets. However, some merging airlines which had already cooperated before were forced by the competition authorities to reduce the anti-competitive effects of their cooperation agreements. In particular, the competitor of Lufthansa-Austrian Airlines on three city-pair markets between Germany and Austria has benefited from the obligation to surrender slots following the formation of an alliance between the two airlines that later became merging partners.

In general, the number of passengers in an origin and destination market (O&D) is a crucial factor for the maximum number of airlines being able to offer direct services. Figure 2 shows the number of O&D passengers on markets subject to remedies and serving at least one airport in Germany. Although there seems to be a clear connection between market size and the number of airlines, some additional factors play an important role. The two monopoly markets with more than 200,000 O&D passengers connect Frankfurt with Zurich and Brussels respectively. Both city-pairs do not only link the hubs of the merging airlines but are also characterized by a high share of business travelers. On the other hand, on the rather small Zurich to Hanover market, two airlines compete. However, additional 60,000 transfer passengers travel between these two airports.

Table 3. Developments on markets subject to remedies (direct flights - short haul only – August 2011)

Merger	No (successful) market entry	Market entry by newcomer	Existing competitor remained or expanded
Air France-KLM	AMS-Paris (CDG) AMS-Lyon AMS-Marseille AMS-Toulouse AMS-Bordeaux AMS-Venice AMS-Bologna	AMS-Milan** AMS-Rome**	
Lufthansa-Swiss	ZRH-Frankfurt* ZRH-Munich ZRH-Copenhagen ZRH-Stockholm ZRH-Warsaw	ZRH-Bucharest	ZRH-Berlin (TXL) ZRH-Dusseldorf ZRH-Hamburg ZRH-Hanover ZRH-Vienna
Lufthansa-Eurowings	VIE-Cologne*** VIE-Stuttgart*** <i>Stuttgart-Dresden</i>		
Lufthansa-SN Brussels	BRU-Frankfurt BRU-Munich BRU-Hamburg BRU-Zurich		
Iberia-Vueling-Clickair	Madrid-Naples Ibiza-Paris <i>Ibiza-Alicante</i> <i>Ibiza-Bilbao</i> <i>Ibiza-Valencia</i> <i>Malaga-Bilbao</i> <i>Sevilla-Bilbao</i> <i>Sevilla-Ibiza</i> <i>Sevilla-Valencia</i>	<i>BCN-Malaga****</i> BCN-Venice	BCN-Athens BCN-Nice BCN-Rome <i>BCN-Granada</i> <i>BCN-Oviedo</i> <i>BCN-Santiago de C. (SCQ)</i> <i>BCN-Sevilla</i> Madrid-Venice
Lufthansa-Austrian Airlines	VIE-Stuttgart VIE-Cologne***		VIE-Frankfurt VIE-Munich VIE-Brussels

Data source: Airline's and airport's websites, EU merger decisions.

Domestic markets in italics.

* Operated for one flight period by Air Berlin (summer 2006)

** Competitor at time of merger ceased operation, other airline (easyJet) entered the market.

*** Former competitor (Air Berlin) has ceased operation.

**** Furthermore, existing competitor continues operation.

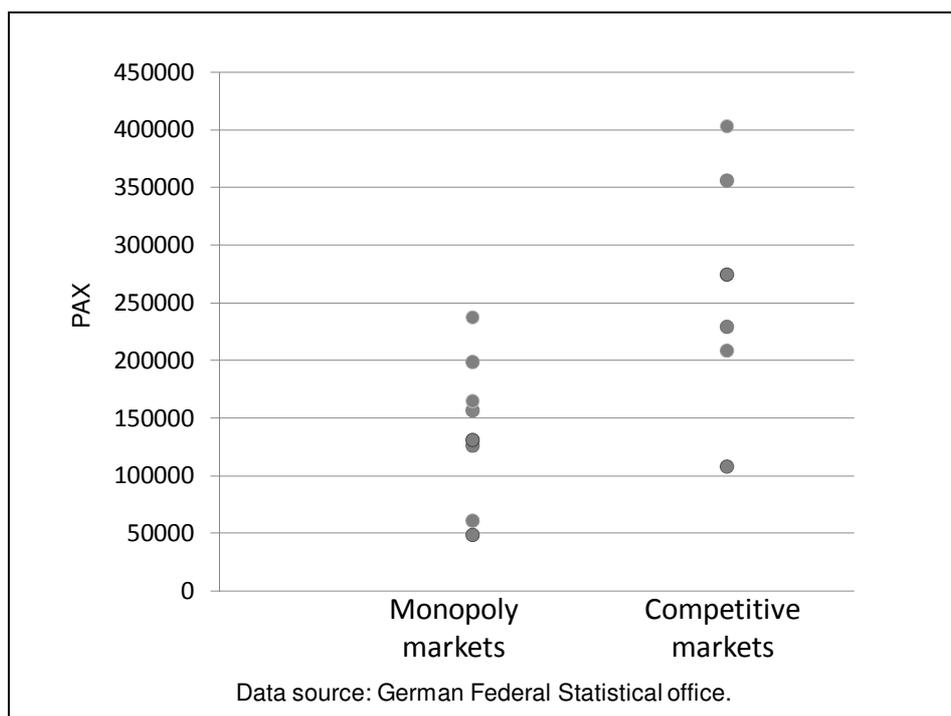


Figure 2. Number of O&D passengers in markets to/from Germany subject to remedies (2009 data)

On some markets active competitors or new entrants later ceased operations (see table 3). However, this does not necessarily indicate the use of predatory practices by the incumbent since other factors might have caused market exit.

In 2008, the European Commission published a note on remedies, stating that commitments “have to eliminate the competition concerns entirely and effective from all points of view” (European Commission 2008, para 9). In more recent decisions, the EC therefore tries to identify potential competitors who are likely to enter the market within a short period of time. In the Lufthansa-SN Brussels merger as well as in the Lufthansa-Austrian Airlines merger, airlines expressing interest in entering particular markets are named in the published decisions. However, none of these airlines actually became an actual competitor. Although the general economic climate in 2009 might not have encouraged market entry, most airlines mentioned in the EC’s decisions are obviously much too small to compete with the largest airline in Europe. It is remarkable that the EC did not analyze the capabilities of potential new entrants more thoroughly.

Whereas new entrants rarely enter monopoly markets involving at least one congested hub, on some markets existing competitors made use of the surrendered slots to increase their frequencies. This can be observed on markets between Germany and Switzerland, which are also characterized by high growth rates, thereby enabling effective competition.

5. CONCLUSIONS

Since 2004 mergers and acquisitions have changed the structure of the European airline industry significantly, in particular increasing the market shares of the three largest traditional network carriers (Air France, British Airways, and Lufthansa). Although the welfare enhancing effects of these mergers are widely acknowledged, on several city pair markets with large passenger volumes mergers led to market dominance, in many cases even to monopolies. Competition authorities try to eliminate these impediments to competition by imposing remedies on the merging airlines, especially the obligation to surrender slots to new entrants or smaller competitors. Although these remedies have been tightened over the years, their success is rather limited.

For future merger control with respect to the European airline industry, several options exist. One way would be to develop even more rigid remedies. However, since competition is per se an open process competition authorities should protect this process rather than try to shape market structure. Moreover, only limited possibilities exist for a further tightening of remedies. As an alternative, competition authorities might accept that the formation of market dominance is an inevitable consequence of some airline mergers which cannot be healed by remedies. This insight might lead to two different strategies. The first option would be to balance the pros and cons of a merger and to base the decision on its net effect. This requires not only a quantitative assessment of a merger's welfare effects, which is a difficult task with presumably controversial results, but also a weighting of consumer's interests in different markets. Furthermore, it is doubtful whether this option would be compatible with the current legal framework. Therefore, as an alternative, the formation or strengthening of market dominance in at least one larger market would have to result in a prohibition of the entire merger. Consequently, the airline industry would have to develop other approaches to increase efficiency. In any case, airline mergers will continue to be the subject of public debate and legal as well as economic analysis.

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