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Ray of Hope for Airline Alliances: Consideration of Out of Market Efficiencies by the European Commission

Manu Mohan*

The article will analyze the application of ‘out of market efficiencies’ to airline alliance agreements by the European Commission. The Commission in May 2013 issued a decision in relation to the revenue-sharing joint venture on certain routes offered by Air Canada, United Airlines, and Lufthansa (who are all members of Star Alliance).

This decision is the first instance where the Commission accepted the argument of out of market efficiencies. Generally, the assessment of efficiencies by the Commission is confined to ‘in market efficiencies’ i.e., the markets where concerns were identified by the Commission. Out of market efficiencies are efficiencies which are generated on the market other than the markets where concerns were identified by the Commission.

According to the standard test set out by the Commission in its Guidelines, efficiencies on other markets can be accepted where: (i) two markets are related; and (ii) group of consumers affected and benefitting are substantially the same. The Parties contended that the cooperation created efficiencies on the Frankfurt-New York route (market on which Commission raised concerns) and on other related behind and beyond routes (e.g., Prague-Frankfurt-New York or Frankfurt-New York-Seattle).

In its decision the Commission broadened the standard test in that it did not require the Parties to demonstrate that the groups of consumers travelling on the Frankfurt-New York route and the related routes are ‘substantially the same’. It was sufficient for the parties to demonstrate ‘considerable commonality’ between passengers travelling on the route of concern and the related behind and beyond route.

This article also considers whether the Commission is justified in restricting the application of out of market efficiencies only to those markets which are related to the relevant market.

* Manu Mohan, Associate, Mayer Brown. Please send comments to mmohan@mayerbrown.com.


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1 AGREEMENT AND OUT-OF-MARKET EFFICIENCIES

Air Canada, Lufthansa, and United Airlines (collectively referred to as the ‘Parties’)† concluded a revenue-sharing joint venture (‘A++ agreement’) that covered, among other things, all passenger air transport services of the Parties on routes between Europe and North America. The A++ agreement provided for cooperation between the Parties on matters relating to price, capacity, scheduling, and revenue sharing.

The European Commission (‘Commission’) expressed concerns that the A++ agreement eliminated competition between the Parties on price and capacity and would harm premium passengers on the Frankfurt-New York route.‡ The Parties offered commitments to address the Commission’s concerns that the A++ agreement may be in breach Article 101(1) of the Treaty of the Functioning of the European Union§ (‘TFEU’), which prohibits anticompetitive agreements. In May 2013, the Commission adopted a commitments decision¶ (‘Decision’) accepting these commitments.

Article 101(3) TFEU makes a legal exception to the prohibition in Article 101(1) TFEU where the agreement’s anti-competitive effects are outweighed or equalled by efficiency benefits. The Commission has defined markets in the airline sector on the basis of demand and supply on routes between individual city pairs.¶¶ The impact of a merger or an alliance is assessed by the Commission on two main categories of passengers defined as ‘time-sensitive/premium’ and ‘non-time sensitive passengers’.†† The Parties contended that the A++ agreement created efficiencies on the Frankfurt-New York route as well as on related behind and beyond routes (e.g., Prague-Frankfurt-New York or Frankfurt-New York-Seattle).

In addition to the in-market efficiencies, such as economies of density and time savings,‡‡ the Parties contended that the agreement would lead to

† The Parties are the founding members of Star Alliance, which has twenty-eight members as of 7 Nov. 2013.
¶ Case COMP/AT.39595 – Continental/United/Lufthansa/Air Canada: decision dated 23 May 2013. The Commission may take a commitment decision based on Art. 9 of Regulation 1/2003. This provision allows companies to offer commitments that are intended to address the competition concerns identified by the Commission. If the Commission accepts these commitments, it adopts a commitment decision making them binding on the parties without, however, establishing an infringement.
†† Ibid., paras 36–41.
‡‡ Economies of density result from the ability of the Parties to increase the load factor, to use a bigger aircraft such as the Boeing 777 instead of the Boeing 767. Time saving arises because (i) under the A++ agreement passengers on the Frankfurt-New York route are able to choose return flight bundles
out-of-market efficiencies such as a reduction in double marginalization. Generally, the assessment of efficiencies by the Commission is confined to in-market efficiencies, i.e., the markets where concerns were identified by the Commission. Out-of-market efficiencies are efficiencies which are generated on markets other than the markets where concerns were identified by the Commission. In a report prepared for the Commission on the competition impact of airline code-share agreements, it was stated that international alliances and code-share agreements have generally benefited passengers. It was also observed in this report that price decreases in 'beyond' markets arise mainly from the removal of a negative externality. This externality (double marginalization) is caused by the separate pricing of segments on an interline trip by different airlines. Within a code-share agreement there is more incentive for partner airlines to consider the overall price of the trip rather than simply the price for the segment that they operate (e.g., if revenues for the trip are shared), which results in lower prices.\footnote{Competition impact of airline code-share agreements, Final Report, January 2007, paras 4.10 and 4.11.}

With reference to double marginalization a joint report by the Commission and the US Department of Transportation suggests that: '[W]hen two firms engage in cooperative pricing of a complementary product each carrier can account for the effect of its pricing, and will price to satisfy demand for the entire itinerary. By doing so, fares are reduced and more interline passengers can be accommodated. The result is that both airlines and consumers are likely to be better off.'\footnote{Transatlantic Airline Alliances: Competitive issues and Regulatory Approaches, Report dated 16 Nov. 2010, paras 101–103.} When two airlines in a supply relationship mark up prices they charge their respective partner above their respective marginal costs, it leads to allocative inefficiency, also called deadweight loss. In a close cooperation such as the A++ agreement these mark-ups could be substantially reduced, leading to lower prices for connecting passengers.

2 ASSESSMENT OF EFFICIENCY CLAIMS RELATED TO THE A++ AGREEMENT BY THE COMMISSION

Since the adoption of the modernization package in 2004,\footnote{Council Regulation (EC) No. 1/2003 of 16 Dec. 2002 on the implementation of the rules on competition laid down in Arts 101 and 102 of the Treaty (OJ L1, 4.1.03, p1). Regulation 1/2003 removed the centralized notification and authorization system for the application of Art. 101(3) TFEU.} the Commission has not 'cleared' by decision any agreements based on efficiencies under Article 101(3)
that offset competitive harm. The Commission is unlikely to bring or close a case that has already been opened in case the anticompetitive effects of an agreement were offset by efficiencies.  

To satisfy Article 101(3), an agreement must satisfy four cumulative, and exhaustive, conditions:

- The agreement must contribute to improving the production or distribution of goods or contribute to technical and economic progress ('efficiency gains');
- Restrictions must be indispensable to the attainment of these objectives ('indispensability test');
- The agreement must not afford the parties the possibility of eliminating competition in respect of a substantial part of the product(s) in question ('possibility to eliminate competition'); and
- Consumers must receive a fair share of the resulting benefits ('fair share to consumers').

2.1 Efficiency gains

The Commission accepted in principle the possibility of both in-market and out-of-market efficiency gains claimed by the Parties. The Commission also accepted that there appeared to be a causal link between the A++ agreement and the claimed efficiencies – thus satisfying one of the conditions in Article 101(3).  

2.2 Indispensability test

After making a detailed assessment of the efficiency claim, the Commission concluded that less-restrictive types of cooperation, such as code-sharing and two-part tariff arrangements, would not substantially reduce double marginalization. The Commission found that, under code-sharing, a marketing airline sells the seats of an operating airline for a transfer price, which often includes a considerable mark-up over an operating party's marginal costs. Elimination of the double marginalization requires the transfer price to be equal to marginal costs. As for the two-part tariff arrangement, the Commission found that

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12 Case COMP/AT.39595 – Continental/United/Lufthansa/Air Canada, para. 65.
13 A two-part tariff arrangement would be, for example, an arrangement where United Airlines would, first, pay Lufthansa an upfront fixed fee for the authorization to sell some seats on Lufthansa's flight Munich–Frankfurt, as part of the itinerary Munich–Frankfurt–New York, and, second, would pay a marginal cost for each of those seats actually sold.
the need to spread the risk between cooperating carriers which are faced with uncertainty in the level of future costs and demand requires adjustments which often requires charging unit prices above the marginal costs.\textsuperscript{14} Therefore, the indispensability test was also found to be provisionally satisfied.

2.3 **Elimination of competition**

The Commission also preliminarily accepted that the A++ agreement would not eliminate competition in the premium market because there were two remaining competitors on the Frankfurt-New York route.\textsuperscript{15}

2.4 **Fair share to consumers**

The Commission considers that the negative effects on consumers in one product or geographic market cannot normally be balanced against, and compensated by, the positive effects for consumers in another, unrelated product or geographic market. The only exception to this position – when efficiencies achieved on separate markets can be taken into account – is where: (i) the two markets are related and (ii) the group of consumers affected by the restriction and benefiting from the efficiencies are substantially the same (hereinafter referred to as the ‘standard test’).\textsuperscript{16}

In performing its analysis, the Commission accepted the Parties’ position that passengers travelling on the Frankfurt-New York route take the same flights as passengers travelling on ‘behind and beyond routes’ (such as Prague-Frankfurt-New York or Frankfurt-New York-Seattle) and that, therefore, the behind and beyond routes are related to the route of concern.\textsuperscript{17} Thus, the Parties were able to satisfy the first leg of the standard test.

With regard to the second leg of the standard test, the Commission preliminarily accepted that there is considerable ‘commonality’ in the consumer groups that travel on the route of concern and related behind and beyond routes, and that there is a two-way flow of efficiencies across these routes.\textsuperscript{18}

The Commission concluded that efficiencies on the related behind and beyond routes would also create efficiencies on the route of concern, including those consumers who did not belong to the common consumer group between

\textsuperscript{14} Case COMP/AT.39595 – Continental/United/Lufthansa/Air Canada, para. 67 and n. 47.

\textsuperscript{15} Ibid. para. 77.


\textsuperscript{17} Ibid. para. 74.

\textsuperscript{18} Ibid. para. 75.
the route of concerns and the related behind and beyond routes. For example, the elimination of the double marginalization would increase the number of passengers on the behind and beyond routes and, therefore, on the route of concern (Frankfurt-New York). This would allow the Parties to add non-stop frequency, or increase the size of the aircraft, which would result in time-savings and economies of density for passengers on the Frankfurt-New York route.

It is important to note that the Commission broadened the standard test; it did not require the Parties to demonstrate that the groups of consumers travelling on the Frankfurt-New York route and the related routes are ‘substantially the same’ in order to credit any efficiencies generated on the related market. Rather, it was sufficient for the Parties to merely demonstrate the ‘commonality of consumer groups’ across these two sets of markets in order to credit a part of efficiencies generated on the related markets. This part of the efficiencies was to correspond to efficiencies accruing to ‘common consumers’. The Parties were able to demonstrate commonality between the Frankfurt-New York passengers and the passengers who fly on the related behind and beyond routes and, thus, benefit from the reduction of double marginalization on those trips.

The Commission emphasized that, under the broadened test, it credits only the out-of-market efficiencies on the behind and beyond routes that also accrue to the passengers on the Frankfurt–New York route. Thus, out-of-market efficiencies enjoyed by the passengers on the related behind and beyond routes, who do not travel on the route of concern, will not be considered by the Commission. Hence, the broadened test does not weigh the harm suffered by one customer group against benefits perceived by another customer group.

On the basis of the broadened test, the Commission’s concerns were dropped on five out of six routes. However, the Commission concluded that, in total, the out-of-market and in-market efficiencies would be insufficient to compensate the harm caused by the A++ agreement to premium passengers travelling on the Frankfurt–New York route.

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19 Case COMP/AT.39595 – Continental/United/Lufthansa/Air Canada, paras 74–76. See also speech delivered by the Director-General for Competition, Commission on 26 Sep. 2013.
20 Case COMP/AT.39595 – Continental/United/Lufthansa/Air Canada, paras 58 and 59. See also Commission press release dated 23 May 2013.
21 The decision of the Commission does not state that concerns were identified in other routes. In a speech delivered by the Director-General for Competition, Commission on 26 Sep. 2013 it was stated that the application of the broadened test led to concerns being dropped on five out of six routes.
EU competition rules have as their objective the protection of competition in the market. Thus, the Guidelines provide that an assessment of benefits under Article 101(3) is, in principle, made within the confines of each relevant market to which the agreement relates. Further, the Commission considers that, since one of the conditions to be satisfied for taking into account efficiencies is that consumers must receive a fair share of the benefits, by implication the efficiencies generated by the restrictive agreement within a relevant market must be sufficient to outweigh anti-competitive effects within that same relevant market. As discussed in section 2 above, the Commission may take into account efficiencies achieved on separate markets if the complementary conditions of the standard test are satisfied.

In its decision, the Commission has broadened the second leg of the standard test. With regard to the first leg of the standard test, it is questionable whether the Commission is correct in restricting the claim of out-of-market efficiencies to related markets. The General Court (then Court of First Instance), in unequivocal terms, held in *Compagnie Générale Maritime v. Commission* that for the purpose of examining the merits of the Commission’s finding as to the various requirements of Article 101(3) TFEU, consideration should be given to the advantages arising from the agreement in question not only for the relevant market, but also in appropriate cases for every other market on which the agreement in question might have beneficial effects - and even, in a more general sense, for any service, quality or efficiency that might be improved by the existence of that agreement. The Court further stated that Article 101(3) envisages exemption in favour of, amongst others, agreements which contribute to promoting technical or economic progress, without requiring a specific link with the relevant market.²²

Thus, neither the language of Article 101(3) TFEU nor the decisions of the Court require that the assessment of out-of-market efficiencies be restricted to related markets. In fact the decision of the General Court comprehensively finds that a specific link with the relevant market is not required.

### 4 CONCLUSION

The broadening of the standard test is a welcome step, and demonstrates the willingness of the Commission to review the policy under Article 101(3) TFEU.

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This broadened test for analysing out-of-market efficiencies is likely to be sought by other alliances under investigation by the Commission.\textsuperscript{23}

Merger cases involving airline networks could seek the consideration of out-of-market efficiencies at the stage of substantive analysis by the Commission. In a study commissioned by a policy department in the European Parliament it is noted that some of the mergers might have led to the implementation of economies of scale and scope. The report further states that in relation to airline mergers, the negative effects stemming from the affected routes were not weighed against potential positive effects on unaffected routes, and that such a weighing exercise could have yielded a positive overall result.\textsuperscript{24}

It could be envisaged that the application of the broadened test could be extended to mergers and in particular to agreements involving network industries such as telecommunication. A study by Copenhagen Economics specifically recommends that competition authorities should be allowed to take the full effect of a merger on every market where the merging companies operate into account, and weigh this effect against possible negative effects on individual markets. This would allow the competition authorities the ability to carry out a more balanced evaluation of proposed mergers.\textsuperscript{25}

Finally, the language of Article 101(3) suggests that the Commission should consider all objective efficiencies arising out of an agreement in any market related or unrelated to the relevant market. Therefore, the Commission may not be justified in restricting the analysis of out-of-market efficiencies to markets related to the relevant market. The validity of this restrictive interpretation by the Commission remains to be tested.

\textsuperscript{23} See press release IP/12/79 dated 27 Jan. 2012. The Commission is currently investigating the transatlantic joint venture between members of the Sky Team.
\textsuperscript{24} The Contribution of Competition Policy to Growth and the EU 2020 Strategy study by Copenhagen Economics, pp. 98 and 99.
\textsuperscript{25} Ibid. p. 46.
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