Competition and regulatory issues in the civil aviation sector

By

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First of all, I would like to thank the South African Civil Aviation Authority for the honour of asking me to be here this morning.

I must, of course, issue the standard disclaimer. My remarks today reflect my own opinions and not necessarily those of the Competition Commission of South Africa ("Commission"). I trust you will understand my reluctance to give great offense to the Commission in the presence of so many airline industry experts.

Considering this, and the cumulative airline industry experience of all of you, I realize the most likely value of my remarks today is simply discussing the competition issues in the airline industry.

But, before I share those with you, I would like to briefly address two central questions. These questions relate to understanding the competitive landscape in which airlines operate today.

The first question is: What does an airline need to enter and compete effectively? This question relates to the barriers to entry.

To enter and compete effectively, an airline essentially needs to overcome both structural and strategic barriers.

Structural barriers include aircrafts (e.g. through ownership or lease), operating licences and traffic rights, labour, feeder access, take-off and landing slots, and access to airport facilities (e.g. check-in facilities and gates).

Strategic barriers originate from the exclusionary behavior of firms present in the market, which raise the costs for new entrants. These barriers to entry include loyalty schemes such as frequent flyer schemes and travel agent commissions which increase customers' loyalty.

The second question is: What do airlines really compete on? This question deals with the main parameters on which airlines compete, namely price and quality.

It is generally accepted that airlines compete first and foremost on prices, i.e. on how much they charge for their flight tickets. Depending on a variety of factors, such as travel date and time, origin and destination, travel class, booking method, number of purchased tickets or loyalty programs, the price a consumer buys a plane ticket can vary significantly. These differences may be explained in part by cost drivers, (for example,flying further away is more costly), but they may also relate to attempts by airlines to discriminate between customers depending on their ability and willingness to pay.

Besides price, quality is another important competitive variable. There are several parameters that affect airline service quality. These include schedule and on-time performance, number of flight cancellations, rate of missing baggage, frequency of overbooking and number of customer complaints.

The quality variable is multi-dimensional and a subjective factor, it depends on what an airline offers and consumer preferences, among others.

I have purposely chosen to begin with posing these questions because understanding the competitive landscape, including barriers to entry and the parameters on which airlines compete, plays a major role in assessing the competition impact their conduct.

With these questions out of the way, you will be happy to know that I only have four main—and rather simple—issues to highlight.

First, I will focus on horizontal agreements, in particular alliances. Alliances are horizontal co-operation agreements falling short of a merger, and vary widely in scope and strength.

Due to increased airline competition, alliances have emerged as a leading trend in the airline industry, ranging from light alliances which include basic interlining and code sharing to high level co-operation and integration agreements which involve coordination on competition parameters such as prices and capacity; sharing of costs and profits; and acquiring a minority interest in allied airlines.

Network economics and the globalization of the economy are behind these alliance strategies. Airlines with bigger networks and worldwide presence have a comparative and competitive advantage over those without. However, for one airline to have it all is unsustainable. Alliances enable airlines to broaden and deepen their network, to grow and to rationalise their costs, without expanding their own aircraft capacity or route offering.

At the same time, alliances may harm competition, for example, by raising entry barriers and leading to higher fares, especially on hub-to-hub and non-stop routes. Both the potential for synergies and the risk of anti-competitive effects may increase with the depth of co-ordination and integration within the alliance.

Internal co-ordination is at the heart of alliances and sometimes requires exemption from competition law. An exemption is written permission received by firms from the Commission to engage in a prohibited practice, should their exemption application meet the criteria set out in the Competition Act.[1]

The Commission first dealt with the issue of alliances in the SAA/Qantas exemption application to code share in 2000. Essentially, SAA requested that it be permitted co-ordinate its commercial passenger airline activities with Qantas in respect of the direct routes between South Africa and Australia in order to maintain or promote exports. The Commission has exempted this code share agreement on six occasions since then (2000, 2002, 2005, 2007 2010 and 2012).

Another example involves the Star alliance. There are three major global alliances, Star, SkyTeam and OneWorld. In 2006, SAA applied for an exemption to join the Star Alliance. The Commission granted SAA an exemption for a period of five years on the basis that the exemption would indeed maintain or promote exports.[2] And in 2010, it applied for the renewal of the 2006 exemption. The Commission granted SAA, a five year exemption.

In November 2013, SAA applied for yet another exemption in respect of a codeshare agreement with Etihad on the route between Abu Dhabi and Johannesburg. The Commission has again,

[1] A firm can apply to the Commission to exempt an agreement or practice, or category of agreements or practices, from the application of the Competition Act, if the agreement or practice contributes to (1) maintenance or promotion of exports; (2) promotion of the ability of small businesses, or companies controlled or owned by historically disadvantaged persons, to become competitive; (3) change in productive capacity necessary to stop decline in an industry; and (4) the economic stability of any industry designated by the Minister of Trade and Industry, after consulting the Minister responsible for that industry.
[2] In 2009, SAA applied for another exemption in respect of a new Star Alliance product called the Meeting Plus.

recently granted SAA the exemption for 5 years on the basis that it is necessary for the maintenance and promotion of exports.

The main controversy around airline alliances revolves around their ability to promote and maintain exports, deliver efficiencies and to increase consumer surplus. There is growing scepticism about whether alliances truly have the potential to benefit consumers and whether any form of competition exemption remains necessary and justified.

My second issue to highlight relates to cartels. The rule against collusion (which prohibits firms from entering into agreements not to compete with one another) is the least controversial prohibition in competition law and is regarded with approval even by those generally skeptical of government interventions in markets.

Unless airlines are subject to an exemption in respect of certain collusive activities, the rule again cartels prohibits airlines from colluding on competition parameters, such as fares, schedules, output, capacity or other sensitive information, as well as allocating markets or customers among them.

For instance, in the course of evaluating the SAA/Qantas application, the Commission discovered that SAA had entered into a number of other bilateral agreements, for which no exemption had been sought. A separate investigation was opened against these pre-existing agreements. The Commission found that one of these older bilateral agreements regulated the relationship between Lufthansa and SAA, including meetings and communications relating to price changes and fare harmonization on flights which they both operated between Cape Town/Johannesburg and Frankfurt. In 2006, the Commission concluded against SAA and Lufthansa's bilateral agreement and through settlement agreements the Competition Tribunal imposed sanctions.

The last five years have been marked by the uncovering of fuel surcharge cartel which involved around 20 airlines worldwide. The cartel was investigated by competition authorities around the world, from the United States, to the European Union, to South Africa.

Considering the South African case, in July 2010, the Commission referred a complaint relating to the fixing of fuel surcharges and cargo rates in international airline freight services to the

Tribunal for adjudication. The respondents in this matter were SAA Cargo, British Airways, Air France-KLM, Alitalia Cargo, Cargolux, Singapore Airlines, Martinair and Lufthansa. The airlines involved are all members of the International Air Transport Association (IATA), an international trade association for major passenger and cargo airlines.

The Commission referred two distinct cases against the airlines. The first case involved the allegations that the airlines concluded agreements, the effect of which was to fix the rate of fuel surcharges on international cargo. In the second case, the Commission alleged that the respondents were involved in price fixing of cargo rates (the rate at which airlines ship cargo on behalf of their respective customers).

The Commission has concluded settlement agreements with some of the respondents in the matter.

The prevalence of cartels is also illustrated in the Far East Asia cartel. In January 2008, the Commission initiated a complaint against SAA, Singapore Airlines and Malaysian Airlines for their involvement with Cathay Pacific in a cartel to fix air fare increases on both economy and business class flights into and out of South Africa to the Far East Asia.

The Commission found that local representatives of these firms fixed air fare rates or prices in South Africa on several occasions during 2004, 2005 and ending February 2006. Cathay Pacific received immunity for its role in the conduct as per the Commission's corporate leniency policy. Singapore Airlines and SAA have settled the case and paid administrative penalties for their participation in the cartel.

SAA, settled this case in the same settlement agreement in which it settled the international air cargo surcharges cartel case.

My third issue to highlight relates abuse of dominant positions. Competition issues in the airline sector are not limited to horizontal agreements, that is, alliances, cartels and mergers, but also relate to abuse of a dominant position. Dominant airlines sometimes may adopt various unilateral practices that can be harmful to consumers.

One common type of exclusionary selling strategy which has been found to have anticompetitive effects relates to reward schemes aimed to increase customer loyalty. While such schemes are very common in the airline industry, if adopted by a dominant airline, they may lead to a breach of competition laws relating to an abuse of a dominant position, depending on their loyalty-enhancing and exclusionary effects.

For an example, in July 2005, the Tribunal found that SAA contravened the Competition Act because it had engaged in prohibited practices in the period from October 1999 to May 2001. I will refer to this case as *SAA I*[3]).

The Tribunal found that the travel agent commission payment scheme implemented by SAA during this period was anticompetitive. This was primarily due to the fact that this scheme had a retroactive (or “back to Rand 1”) structure.

The Tribunal decision in SAA I decision, relied on the extensive evidence of the ability and incentives of travel agents to divert traffic between airlines (that is, engage in so-called “directional selling”) as a result of performance schemes such as the ones offered by SAA. This evidence was based in turn on factual testimony from travel agents and airline executives, rather than just on data on travel agent sales.

For this conduct, the Tribunal imposed an administrative fine of R45 million.

However, various similar agreements remained in place beyond 2001. Comair lodged a complaint with the Commission about these post-2001 agreements in October 2003. The complaint was referred by the Commission to the Tribunal for adjudication in October 2004.

Shortly after the SAA I, SAA’s agreements were changed. The elimination of the retroactive design of the incentive contracts, applicable from April 2005, then formed part of a settlement agreement with Commission. The Tribunal confirmed the settlement agreement in December 2006. SAA agreed to pay an administrative fine of R15 million.

[3] Competition Tribunal of South Africa, *Competition Commission v South African Airways (Pty) Ltd* (Case No. 18/CR/Mar01)

The settlement agreement did not contain an admission of liability on the part of SAA for the period between May 2001 and March 2005. As a result, Comair and Nationwide chose to continue to fight the case at the Tribunal. A finding of contravention is a prerequisite for the institution of an action in the High Court for damages.

In February 2010, the Tribunal found that SAA had abused its dominant position during the period between May 2001 and March 2005. Essentially, SAA II related to similar conducted covered in SAA I, the only difference being that the SAA II decision extended the analysis of effects that is contained in SAA I.

The SAA cases represent a clear example of why rivals in the market were not able to profitably match the incentive schemes of SAA which led to their foreclosure in the domestic market.

The last issue I would like to highlight relates to financial distress and government intervention. Globally, the airline industry is famous for number of distressed firms, bankruptcies and market exits. In the case of South Africa, three low-cost domestic carriers have exited the market in recent times (Nationwide, Velvet Sky and 1Time). Nationwide, Velvet Sky, 1time were privately owned airlines that operated between 1995 to 2008, 2011 to 2012 and 2004 to 2012 respectively.

Several questions remain unresolved in the airline sector. Is financial distress inherent to the industry? Are airlines condemned to face financial difficulties at some point? What explains that legacy carriers are struggling, whereas some low-cost carriers have been successful? Is it a matter of good management, business model, market structure, state support, or deregulation?

When we discuss financial distress we must keep in mind that financial distress results from a combination of internal and external factors. Internal factors primarily pertain to bad management decisions, including excess capacity investments, inflated personnel, excessive bureaucracy, unprofitable routes and ineffective network planning. External factors often relate to fuel price volatility, financial and economic crises, shifting demand, labour costs or increased effective competition.

On the question of effective competition, in highly competitive markets, only the most profitable and well-managed carriers may be sustainable. This holds true for any industry, as competition rewards the most efficient players at the expense of the others.

Where business recovery tools fail, the South African government, like others elsewhere, has faced the tough questions of whether or how to respond. It is not an overestimation to suggest that in the airline industry, failure to intervene may have enormous harmful consequences, such as reduced access and frequency of air transport, adverse labour and social impact, lower coverage of small or remote areas, negative impact on related businesses. These are reminders that, airlines serve the public interest and global economy, and are not easy to replace.

Several airlines in South Africa have in recent years been making losses. Chief among them is SAA. Government support to SAA has been in the form of concessionary financing and guarantees. For example, SAA recently received a R5.006 billion guarantee from Government effective from 1 September 2012 to 30 September 2014. The effect of this support is to reduce the cost of borrowing for SAA to below market levels and to reduce SAA's perceived risk.

Even while SAA is a state owned company, government support is often controversial, as it comes with a number of challenges, let alone the risk of a failed rescue plan. The first challenge is that government support to only one airline may distort the playing field. A second challenge is that government support may increase inefficiencies overall, as it sends a strong signal that inefficient airlines can be rescued. This challenge consists of determining whether the adverse consequences of letting a carrier fail, outweigh the risks of un-levelling the playing field and of inducing potential long-run inefficiencies.

The Commission has not assessed complaints relating to the exercise of public powers. Case law suggests that competition authorities cannot review any decision taken by government departments. However, where the state exercises its power through a vehicle such as a firm, competition authorities have intervened.

Perhaps what is needed is a framework that allows for a balance between the goals of correcting market failures, providing public goods and fostering economic development with possible inefficiencies and anti-competitive effects. This could for instance mean targeted government support only for those routes which serve the purpose of providing public goods.

Yet such a framework, could at the same time, put the competitiveness of the SA airline industry at a competitive disadvantage in relation to the rest of the world, where state support remains un-regulated.

To conclude, like elsewhere around the world, the South African airline sector has undergone a several significant changes in recent decades. These changes have significantly transformed the structure of the airline sector and, in many ways, affected its competitive intensity. On the one hand, we have seen the entry of low-cost carriers, like Kulula which have increased the intensity of competition in domestic routes. On the other hand, diverse forms of horizontal agreements, like codeshare agreements and alliances, which have increased the consolidation of the global industry. Several barriers to entry also remain, sometimes as a result of conduct by some airlines.

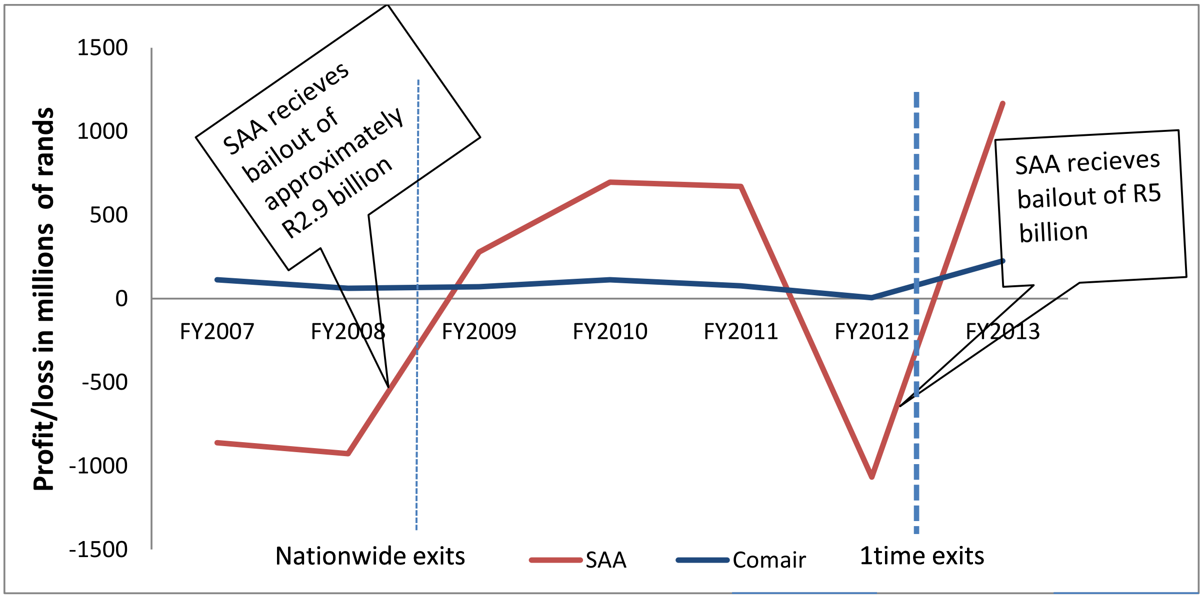
The Commission's principal role in the airline sector is to promote and maintain competition in order to contribute to inclusive growth. These current features in sector raise challenges with regards to effective competition.

Thank you.

Exemption	Duration	Lapsing Date	Nature of Exemption
SAA and Qantas	1 year 6 months	30-Jun-02	Co-ordinate commercial passenger airline activities
	2 years	18-Dec-05	
	2 years	31-Dec-07	
	3 years	31-Dec-10	
	2 years	31-Dec-12	
	1 year 6 months	31-Dec-13	
SAA/Star Alliance	5 years	31-Dec-10	Star Alliance and joint Star products
	1 year	31-Dec-10	Participation in Meeting Plus.
	5 years	31-Dec-15	Participation in the Star Alliance and joint Star products
SAA/Etihad	5 years	31-Dec-19	Joint pricing and schedule coordination on primary and secondary routes

Case	Market	Conduct
British Airways (EU, 1999, 2003, 2007)	Airline ticket sales to travel agents	Retroactive commissions with individualised growth targets
BA v. Virgin (US, 2000)	Airline ticket sales to travel agents	Conduct found not to be predatory/abusive
SAA I (SA, 2005)	Airline ticket sales to travel agents	Retroactive commissions with individualised growth targets
SAA II (SA, 2010)	Airline ticket sales to travel agents	Retroactive commissions with individualised growth targets and lump-sum payments

Issue	Decision in ***SAA I***	Issues in ***SAA II***
Market definition	Broad airline market defined (all routes/passengers)	Growth of Low-Cost Carriers (**LCCs**) since 2001. Raises issue of further differentiation
Contract design	Use of base and incremental retroactive overrides found to be anti-competitive	Incremental override abolished. "TRUST" payments introduced instead.
Directional selling by travel agents	Significant ability to divert traffic by agents	Does the rise of internet bookings / greater transparency constrain agents?
Effects on competitors	Some evidence found, but for limited period (up to 2001)	Longer time period available (up to 2007). Evidence of growth for Comair group combined (BA + Kulula) and for Nationwide
Effects on consumers	Consumers were harmed since they had to rely on travel agents to make their bookings	Does growth of LCCs allow consumers to by-pass the adverse effects of SAA's conduct?


Profit/loss in millions of rands
1500
1000
500
0
-500
-1000
-1500
FY2007
FY2008
FY2009
FY2010
FY2011
FY2012
FY2013
SAA recieves bailout of approximately R2.9 billion
SAA recieves bailout of R5 billion
Nationwide exits
1time exits
SAA
Comair