Air France/KLM: Drawing the Antitrust Map for European Airline Consolidation

By Charles S. Stark

On February 11, 2004, the European Commission (the Commission) cleared Air France's acquisition of KLM Royal Dutch Airways,[1] subject to a web of commitments by the carriers as well as the French and Dutch aviation authorities. The same day, the U.S. Department of Justice's Antitrust Division (Justice) cleared the deal by agreeing to "early termination" of the U.S. pre-merger waiting period. Although Justice closed its investigation unconditionally, a Justice official said afterward that its approval was partly based on the remedies imposed in Brussels.[2]

The Commission's decision is worth examining closely. Most immediately, it suggests that the Commission is likely to take a hospitable antitrust approach to the expected consolidation of the European airline industry.

The decision also highlights the extent to which the United States and the European Union (EU) antitrust agencies' analytical approaches to airline markets have converged—and at the same time highlights important and persistent differences at the bottom line, e.g., in their approaches to remedies. The Commission remains more amenable than Justice to accepting fixes designed to facilitate new entry or expansion by competitors on concentrated overlap routes.

These similarities and contrasts come into relief when we juxtapose the Commission's approval of the Air France/KLM merger with Justice's 2001 challenge to the United/US Airways merger.[3] The two deals were, in a way, transatlantic mirror images of one another. Both involved extensive overlapping routes in the carriers' home continents, as well as a limited number of transatlantic route overlaps that led to the deals being reviewed on both sides of the ocean. In Air France/KLM, the Commission found competition problems on a number of intra-European routes. In United/US Airways, Justice, using a similar analysis, had found competition problems on a number of domestic U.S. routes. But while the Commission and the European carriers reached agreement on remedies on the overlap routes and allowed the deal to proceed, the United/US Airways deal was abandoned in the face of Justice's threatened suit.

EU Antitrust Rules for Air Transport

A quick summary of the way in which EU antitrust law applies to air transport will help to put the Commission's decision into context. In a nutshell, EU antitrust law now applies to air transport—both intra-European and intercontinental—in essentially the same way it applies to other industries. It covers mergers, alliances, conduct by dominant firms, distribution, and the full range of arrangements covered by EU antitrust law.

In historical terms, however, the application of EU antitrust rules to air transport is a relatively recent development. Antitrust regulation of air transport initially was carved out of European antitrust coverage and has been only incrementally reinserted:

EU-level merger regulation first came into effect in 1990, and since then it has applied to airline mergers just as to other mergers.

A series of intra-European air transport liberalization measures culminated in 1992 with the creation, in legal terms at least, of a single, EU-wide aviation market, eliminating economic-based regulation of fares, capacity, and nationality-based distinctions among carriers of EU Member States, and applying antitrust rules to carriers' conduct in intra-EU markets.

The last jurisdictional gap was eliminated when, effective May 1, 2004, the Commission was given full antitrust enforcement powers over conduct involving routes between the EU and third countries. Until then, the Commission could investigate but could not take direct enforcement action in connection with international aviation arrangements. If it found a competition problem, it had to rely on the Member States to impose a remedy if the airlines didn't agree—although the process was never tested, as in practice the Commission and the airlines involved tended to work their way toward agreement.[4]

The Air France/KLM Decision

Air France/KLM is the first merger of European flag carriers in a period in which the Commission has been encouraging, and everyone recognizes the inevitability and necessity of European airline consolidation. The demise of Sabena and Swissair, and the well-publicized financial straits of Olympic and Alitalia, among others, are testimony to the passing of an era in which national carriers could survive through state subsidies, protected routes, and regulated fares. Whatever antitrust issues the Air France/KLM merger might or might not have presented, the Commission cannot have been anxious to reach a conclusion that would kill the deal and hoist a red flag over the consolidation track.

The Companies and the Deal

Air France is, of course, the principal French airline and was 54 percent owned by the French government before the transaction. Its main hubs are at Paris: Charles de Gaulle airport for international flights, and Orly for domestic flights. It is a member of the SkyTeam alliance, which includes Alitalia, Delta, CSA Czech Airlines, Korean Air, and AeroMexico.

KLM is the principal Dutch airline, although the Dutch government's ownership before the merger had been reduced to 14 percent. Its hub is Schiphol airport at Amsterdam. KLM has an alliance with Northwest and has a subsidiary (Transavia) that operates charter and low-cost/low-fare scheduled services.

The deal, which was completed in early May, was structured as an acquisition by Air France of all of KLM's shares. Initially, however, Air France will have only 49 percent of KLM's voting rights, the

rest remaining in Dutch hands. Air France and KLM will retain their separate identities, although their operations will be coordinated.

In addition to passenger transport, both companies have operations in cargo transport and in maintenance, repair, and overhaul services (MRO).

The Antitrust Issues

The Commission considered the merger's impact on competition in the passenger transport, cargo transport, and MRO segments, but it found no significant issues in cargo or MRO. On the cargo side, the Commission found the market to be Europe-wide or continent to continent, and it found no competition problems (although combined cargo market shares between Europe and Latin America might be as high as 55 percent, and those between Europe and Mexico as high as 75 percent). The Commission noted that cargo customers rarely, if ever, express a preference for nonstop service; that air cargo customers in some cases have considerable buying power; and that cargo customers are less influenced in their carrier choices than are passengers by brand or national loyalties.

On the MRO side, the Commission viewed the market as worldwide, except for line maintenance that is inherently local, but it found the parties' combined market shares in all segments to be low and the presence of substantial competitors pervasive.

Most of the Commission's decision focused on passenger transport markets.

Market Definition

Antitrust outcomes often turn on market definition. Whether a merger or particular conduct is viewed as limiting competition can depend on what market the agency focuses on. The same operations may account for a very large share of a narrowly defined market—e.g., time-sensitive passengers traveling between Paris and Amsterdam—or a small share of a broadly defined market—e.g., worldwide, or European, airline networks.

Network competition vs. city-pair competition. In this case, the airlines urged the Commission to view the merger through the lens of network competition. They noted that network carriers and their alliances increasingly compete for contracts with corporate customers based on the reach of their networks.

The Commission, however, held to its traditional focus on city pairs, or point-of-origin/point-of-destination pairs, insisting that airline competition should be evaluated mainly in terms of "demand substitution"—e.g., the alternatives available to individual passengers. If Air France and KLM have a near monopoly of Paris-Amsterdam traffic, it doesn't matter to a passenger traveling on that route, the Commission said, whether other networks compete with the combined carrier on other routes. As for corporate customers, the Commission said, companies focus on fares on individual routes as well as overall discounts, and commonly contract with more than one carrier to get the best prices on routes they use heavily.

Available substitutes on city pairs. Where the airlines (or one of their alliance partners—see the "Alliances" discussion below) overlap and account for a substantial share of traffic on a city pair, the merger's impact on competition for passengers on that route may depend on the alternatives reasonably available to those passengers. The Commission examined three categories of possible substitutes: (1) substitution between nonstop and indirect flights; (2) substitution by a flight to or from another nearby airport;[5] and (3) substitution by ground transportation, particularly by high-speed train service. The availability and impact of any of these substitutes would be evaluated separately for each overlap route on which there otherwise appeared to be a colorable competition issue.

Time-sensitive vs. non-time-sensitive passengers and direct vs. indirect flights. The Commission, like most antitrust agencies, analyzes airline markets separately for a merger or alliance's impact on time-sensitive (usually business) and non-time-sensitive (usually leisure) passengers. As a rule of thumb, time-sensitive passengers are assumed to be willing to pay higher fares for nonstop flights, airports nearer their ultimate departure and destination points, higher schedule frequencies that allow them more closely to tailor their travel schedules to their business needs and by frequent flyer programs. A presumption has been that for time-sensitive passengers, indirect flights are not substitutes for nonstop flights.

The Commission already had departed from the latter presumption in its United/US Airways decision, concluding that on long-haul (transatlantic) flights, one-stop service could be an adequate substitute for nonstop service even for time-sensitive passengers. In Air France/KLM, the Commission refined its view to adopt a new presumption, deciding that long-haul flights with a connection time of not more than 150 minutes normally are substitutable for nonstop service for time-sensitive passengers.

Assessing the Impact on Competition

Alliances. Alliances are an increasingly pervasive feature of the airline industry, but the scope of cooperation and integration among alliance members can vary considerably. When airline A merges with airline B, do B's alliance partners continue to be A's competitors or potential competitors, or does the merger effectively eliminate competition between A and all of B's alliance partners? In United/US Airways, for example, the Commission's view was that the merger would eliminate competition not only between the merging airlines, but also between US Airways and United's Star Alliance partner Lufthansa. On transatlantic routes, the Commission seems to view alliance partners operating with Department of Transportation (DOT) antitrust immunity as though they were a single firm on the immunized routes (e.g., most United-Lufthansa transatlantic routes). For non-immunized routes, the Commission's conclusions seem more particularlized.

In Air France/KLM, the Commission concluded that the alliance would eliminate competition between the two airlines and their respective alliance partners on a number of routes covered by the alliances: transatlantic routes on which

Charles S. Stark is a partner in the Brussels, Belgium, office of Wilmer Cutler Pickering Hale and Dorr LLP, where his practice centers on EU and U.S. antitrust law. Before joining the firm in 2001, Stark was chief of the foreign commerce section of the U.S. Department of Justice's Antitrust Division.

Air France's SkyTeam partners operate with DOT antitrust immunity; the Paris-Prague route, on which CSA Czech Airlines has an alliance with Air France; transatlantic routes on which KLM and its alliance partner Northwest Airlines operate under DOT antitrust immunity; and the Amsterdam and Nairobi route, which KLM operates with Kenya Airways.

In addition, the Commission concluded that the merger would eliminate competition between KLM and Alitalia because Alitalia and Air France already had agreed, subject to Commission approval, to broad cooperation on intra-European routes. On the other hand, the Commission decided that Continental, which operates two code-share routes between Amsterdam and the United States with KLM, but without antitrust immunity, should continue to be viewed as a competitor on transatlantic routes.

Analyzing the routes: Intra-European routes. The Commission chose to focus on each city pair between the Netherlands and France or between the Netherlands and Italy on which KLM, Air France, and/or Alitalia had nonstop service.[6] All but one of the city pairs the Commission examined, and all of the city pairs on which it found a competition issue, involved Amsterdam. The Commission concluded that the combined carriers would have dominant positions on the hub-to-hub routes of Amsterdam-Paris and Amsterdam-Lyon, and Amsterdam-Milan and Amsterdam-Rome, where Air France and Alitalia, respectively, with KLM, accounted for most or all nonstop service.

There will not always be an easy way—perhaps any way—to preserve competition on every route.

The Commission also saw a risk of dominance on Amsterdam routes on which (1) KLM already was dominant and either or both of Air France or Alitalia had shares of less than 5 percent, which the Commission nonetheless viewed as a competitive constraint on KLM (Toulouse, Bologna, Venice), or (2) KLM's direct service and Air France's indirect service accounted for all but a very small percentage of the traffic (Bordeaux, Marseilles).

Analyzing the routes: Long-haul routes. The carriers had identified 73 long-haul routes on which they had nonstop/nonstop, nonstop/indirect, or indirect/indirect overlaps. The Commission had a serious competition concern on five of the routes.

Although Air France did not fly the nonstop Amsterdam-New York route, its SkyTeam partner Delta did, in competition with the KLM/Northwest alliance. Collectively, the three carriers carried 55 percent to 65 percent of all passengers originating and ending their trips in Amsterdam and New York, and 27 frequencies at the capacity-constrained Schiphol compared with seven for the next-largest carrier on the route (Continental).

On two transatlantic routes, the merger would have eliminated nonstop/indirect competition and, in the Commission's view, eliminated the likeliest additional nonstop competitor. On the Paris-Detroit route, Northwest operated nonstop in competition with indirect service by Delta, Air France, and KLM. Combined, the carriers have more than 90 percent of the traffic on the route. The Commission viewed the route as capable of supporting two nonstop competitors and saw Air France, with its Paris hub, as the likeliest to start new nonstop service. Between Amsterdam and Atlanta, Delta operated nonstop service in competition with indirect service by KLM/Northwest, Air France, and Alitalia. Absent the merger, the Commission thought KLM might resume the nonstop service it had once operated.

Lastly, the Commission was concerned about the elimination of competition on the Amsterdam-Lagos and Paris-Lagos routes, where KLM's indirect Paris-Lagos service was the main competitor to Air France's nonstop service, and Air France's indirect Amsterdam-Lagos service competed with KLM's nonstop flight.

None of the indirect/indirect overlaps posed a problem for the Commission because in all cases there was other substantial direct or indirect competition. The Commission did note that there were another 18 nonstop/indirect overlaps on which the merging carriers' combined share was between 45 percent and 85 percent, but that there was enough other direct or indirect competition on those routes to alleviate its concerns.[7]

The Commission's Remedies

Having identified a number of routes on which the merger would have an anti-competitive impact in violation of the Merger Regulation—although a small number in relation to the carriers' overall networks—the Commission either had to come to agreement with the carriers on a way to eliminate the problem areas or to prohibit the merger. The Commission does not have the U.S. antitrust agencies' leeway to allow a merger by simple inaction as a matter of prosecutorial discretion; it has to explain its reasoning, publicly and in writing, and in antitrust terms, whether it decides to challenge a merger, to allow it, or to let it proceed subject to conditions.

There are basically three ways, other than prohibition, to deal with lessening of competition that may result from a merger. One is divestiture: selling part of the overlapping business to another firm that will operate it in competition with the merged company. A second is to put measures in place to encourage, or to avoid discouraging, new entry or expansion by competitors that will erode the merged firm's market power. A third is to regulate: to accept that the merged firm may have a degree of market power, but to limit its ability to exploit that market power, or to require it to share its advantages with competitors. The Commission's remedies in Air France/KLM have aspects of all three.

The main components of the Commission's remedies package are:

Slot divestitures. The carriers agreed to give up slots, without compensation, at capacity-constrained airports in Amsterdam, Paris, Lyon, Milan, and Rome to allow new entrants to operate new or additional nonstop daily services. The slots have to be within 30 minutes of the times requested by the new entrant for intra-European routes or within 90 minutes for long-haul routes. Unlike slot divestitures required in previous Commission cases, the divestitures are permanent. If the new entrant stops using them, they go back into the airport's slot pool, not

back to the carrier that gave them up.

Frequent flyer programs. The carriers will allow new entrants, on request, to participate in the carriers' frequent flyer programs on the same basis as the carriers' alliance partners.

Interlining. The carriers will enter into interline agreements with new entrants if requested.

Frequency freeze. The carriers will not add new frequencies on the Paris-Amsterdam or Lyon-Amsterdam hub-to-hub routes for six seasons.

Special prorate agreements. The carriers will enter into prorate agreements with new entrants, if requested, for traffic to or from France or the Netherlands, if part of the trip includes the Amsterdam-Paris city pair. The terms will be the same as those applied to the carriers' alliance partners.

Blocked space agreements. The carriers will enter into a blocked space agreement with new entrants, if requested, on routes between Amsterdam and Marseille, Toulouse, or Bordeaux, if part of the trip includes the Amsterdam-Paris city pair.

Intermodal service. The carriers will enter into intermodal agreements with rail or other ground transportation providers between France and the Netherlands or Italy and the Netherlands (designed to strengthen, e.g., high-speed rail competition on the Amsterdam-Paris route).

Fares. Any reduction in published fares between Paris and Amsterdam will be matched by an equivalent reduction in fares between Lyon and Amsterdam, as long as there is no competitive service on the latter route. The rationale for this provision is twofold. First, it is intended to discourage predatory price reductions to chill entry on the Paris-Amsterdam route by spreading the reduction to a second route. Second, it is intended to provide surrogate competition on the Amsterdam-Lyon route, which will benefit from competitive price reductions on the Amsterdam-Paris route.

Appointment of a monitoring trustee. The Commission and the carriers will agree to appoint a monitoring trustee whose job will be to resolve issues arising under the carriers' commitments. The rationale is that it will be a more efficient and effective way of ensuring compliance with the measures than having to go back to the Commission in each instance.

Assurances by the French and Dutch aviation authorities. The French and Dutch aviation authorities agreed, as a quid pro quo for the Commission's approval of the merger, not to apply their bilateral air services agreements with third countries to limit price leadership by competing carriers' sixth freedom flights, or to deny fifth freedom rights where necessary to inject competition from new carriers into long-haul routes on which competition would otherwise be reduced by the merger. Specifically, the Dutch authorities agreed to grant fifth freedom rights to allow one additional daily service between Amsterdam-New York, Amsterdam-Atlanta, and Amsterdam-Lagos. The French authorities did the same for the Paris-Detroit and Paris-Lagos city pairs. Both authorities agreed not to restrict sixth freedom price leadership by carriers on these routes and a list of other routes from Paris or Amsterdam on which the Commission was concerned about a loss of competition.

What Would Justice Have Done?

The U.S. antitrust agencies and the Commission have had an antitrust cooperation agreement in place since 1991. Their interaction, especially when working together in reviewing the same transaction, has led to extensive, if still imperfect, convergence in their analytical approaches.[8] The similarity in their approaches to airline market definition is a good example of that convergence. Both agencies have so far stuck to their focus on city-pair markets. Both have taken similar approaches to the analysis of competition issues associated with hub markets. Both have taken similar approaches in treating carriers operating within tightly integrated and immunized alliances as part of a single competitive unit rather than as competitors. Indeed, a senior Justice official said his agency had viewed the deal as, in effect, a merger of two code-sharing alliances.[9] And, as already noted, Justice cleared the deal because whatever concerns it might have had in connection with any affected transatlantic routes were alleviated by the Commission's remedies.

But there are differences. For one, Justice continues to identify markets for time-sensitive passengers with nonstop flights, even on long-haul routes where the Commission has come to accept one-stop flights with reasonably short connecting times as substitutable.

But the most important difference between Justice and the Commission is their approaches to remedies. Although Justice's decision to challenge the United/US Airways merger did not produce a detailed public explanation of its rationale, it is apparent that Justice is less willing than the Commission to bet on new entry in city pairs in which it has identified a competitive problem. Nor has Justice been inclined to try to promote entry by requiring the incumbent merging carriers to share their frequent flyer programs or enter into other agreements with competitors to induce them to enter the markets.[10]

These differences reflect, in part, differences in the nature of the institutions. Even in its antitrust enforcement role, the Commission has been more open than has Justice to "regulatory" remedies. It has more of a tendency to regulate markets to ensure a more level playing field, while Justice is more reluctant to adopt non-structural remedies that may require continued supervision.

In addition, the Commission has a broader role in airline industry restructuring than does Justice. Justice was a key advocate for U.S. airline deregulation, but its direct role is limited to antitrust enforcement—while the Commission's responsibilities include, but aren't limited to, antitrust. The Commission has actively promoted industry consolidation, and in its antitrust enforcement role it cannot be unaware of the implications of its enforcement decisions for its broader policies. Airline consolidation inevitably will eliminate overlapping services on some routes, and there will not always be an easy way—perhaps *any* way—to preserve or restore competition on every route. The Commission's approach

might be seen as a best effort to mitigate the costs of lessened competition on discrete routes while pursuing the broader aim of promoting a more efficient, and ultimately more competitive, airline industry structure.[11]

The Justice Department, on the other hand, has a single mandate in relation to airline mergers: enforcing the antitrust laws. If a merger substantially lessens competition in a market, and that effect can't be avoided in a reasonably certain way, Justice's role is to challenge the merger. But Justice itself recognizes that there are tradeoffs, and that blocking a deal because of its impact on discrete city-pair routes may sacrifice other benefits and yield a less efficient and competitive outcome in the broader market than might otherwise be achieved.[12]

Conclusion

The Commission's Air France/KLM decision is an important and, for the most part, welcoming signal to European airlines looking toward an era of consolidation. It highlights broad agreement but outcome-determinative differences between the EU and U.S. antitrust agencies' current approaches to airline mergers. The agencies have a remarkable record in recent years in marking out common approaches to key antitrust challenges. The airline industry, in the throes of structural change and crucial to the global economy, should be a priority item on their convergence agenda.

Notes

1. Case No. COMP/M.3280 - Air France/KLM (Feb. 11, 2004), at http://europa.eu.int/ comm/competition/mergers/cases/ decisions/m3280_en.pdf

2. J. Bruce McDonald, deputy assistant attorney general, Antitrust Division, Department of Justice, Transportation Update: Remarks to the ABA Section of Antitrust Law Transportation Industry Committee, Washington, D.C., Mar. 31, 2004, at www.usdoj.gov/atr/public/ speeches/203369.pdf.

3. Department of Justice Press Release, *Department of Justice and Several States Will Sue to Stop United Airlines from Acquiring US Airways*, July 27, 2001, at www.usdoj. gov/atr/public/ press_releases/2001/8701.pdf.

4. The Member State antitrust authorities do, however, expect to continue to review airline matters of a more local nature. The European Competition Authorities, an organization of Member State antitrust officials, has just issued a study of Member State antitrust enforcement practices regarding airline mergers and alliances, at http://europa.eu.int/ comm/competition/publications/eca/ report_air_traffic.pdf.

5. On this point, the Commission concluded that New York's JFK and Newark airports are substitutable destinations for European passengers; Paris's Charles de Gaulle and Orly airports are substitutable for point-to-point passengers, but Charles de Gaulle is preferable for connecting traffic; and Milan's Malpensa and Linate airports are substitutable for point-to-point traffic, but Malpensa is preferable for connecting traffic.

6. The Commission noted that the carriers have nonstop/indirect overlaps on city pairs that end in other European countries, but did not explain why it chose not to examine those city pairs.

7. Unfortunately, the Commission's decision does not explain the distinctions that led it to identify a problem with the carriers' combined direct/indirect share of up to 65 percent on the New York-Amsterdam route, while not finding a problem on other routes on which their direct/indirect share might reach 85 percent.

8. Of course, that convergence is far from total, as we were reminded when the Commission threatened to scuttle the 1997 Boeing/McDonnell Douglas merger after it had been cleared by the U.S. Federal Trade Commission, and again in 2001 when the Commission prohibited the GE/Honeywell merger after it had been cleared by the Justice Department.

9. *See* McDonald, *supra* note 2.

10. R. Hewitt Pate, deputy assistant attorney general (now assistant attorney general), Antitrust Division, Department of Justice, Statement Before the Subcommittee on Antitrust, Competition, and Business Rights Committee on the Judiciary United States Senate Concerning International Aviation Alliances: Market Turmoil and the Future of Airline Competition, Nov. 7, 2001 ("We concluded that United's proposal to divest assets at Reagan National Airport and American Airlines' promise to fly five routes on a nonstop basis were inadequate to replace the competitive pressure that a carrier like US Airways brings to the marketplace, and would have substituted regulation for competition on key routes."), at www.usdoj.gov/atr/public/testimony/9508.pdf.

11. It is unlikely the Commission itself would describe its Air France/KLM in this way.

12. *See* Public Comments of the Department of Justice in the U.S.-U.K. Alliance Case, Department of Transportation Docket OST-2001-11029, Dec. 17, 2001 ("Under the applicable statute, the Department of Transportation must evaluate the competitive harm of a transaction, but may "trade" competitive harm in some markets for other public benefits, including improved competition in other markets, that are made possible by the transaction, and that cannot be achieved by less anticompetitive alternatives."), at www.usdoj.gov/atr/public/comments/9712.pdf.