



## **Loyalty programmes in civil aviation**

- an overview of the competition issues concerning frequent flyer programmes, corporate discount schemes and travel agent commissions

**The analysis set out in the present document does not legally bind the members of ECA in any way and thus cannot form the basis for any legal action. The paper is the result of discussions within the institutional framework of the ECA Air Traffic Working Group and does not have the status of an official notice or guideline published by one of the national authorities, the European Commission or the EFTA Surveillance Authority. Moreover, it is emphasised that any individual matter will be decided on a case by case basis.**

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## I. Introduction

1. During the sessions in Athens on 15 and 16 April 2002 the European Competition Authorities (ECA)<sup>1</sup> set up an Air Traffic Working Group in order to improve cooperation between them in relation to their dealings with the airline industry and to seek to enhance the present degree of competition in this sector. The ECA are of the opinion that competition between airlines is influenced by some specific features of the airline industry, in particular its network character. In view of the ongoing consolidation process in the European airline industry and new market developments, high priority has been given to a more uniform and consistent application of the competition laws of the national states and the European Union.
2. The purpose of the present document is to provide an overview of the current competition enforcement practices of the ECA with respect to travel agents commissions and loyalty enhancing measures taken by the airlines such as corporate discount schemes and frequent flyer programmes in the passenger air transport sector<sup>2</sup>. One aim of such schemes and programmes is to influence the behaviour of travellers in such a way that they become more inclined to seek a specific airline's products and services. The Air Traffic Working Group has identified them as potentially serious obstacles to effective competition.
3. Since the authorities' enforcement experience in the field of passenger air traffic is still limited, it is emphasised that the present document does not address all questions that may arise in the assessment of any loyalty enhancing measures of the aviation industry. Against this background, the ECA Air Traffic Working Group may modify or amend the present document from time to time as the authorities' enforcement experience develops further.
4. In 2004, the Norwegian and the Swedish Competition Authorities elaborated a paper on frequent flyer programmes, which initiated several discussions within the ECA Air Traffic Working Group on loyalty issues. In order to broaden the scope of the subject area, a questionnaire was circulated among the ECA members. 17 answers to the questionnaire have been received. Replies came from Austria, Denmark, Estonia, Finland, France; Germany, Greece, Hungary,

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<sup>1</sup> The European Competition Authorities consist of the competition authorities in the European Economic Area (EEA) (the 25 Member States of the European Community, the European Commission, the EFTA States Norway, Iceland, Liechtenstein and the EFTA Surveillance Authority).

<sup>2</sup> I.e. cargo services are not considered in this document.

Italy, Lithuania, Norway, Poland, Spain, Sweden, United Kingdom, the European Commission and the EFTA Surveillance Authority. The main results of the questionnaire, the paper prepared by the Norwegian and the Swedish Competition Authorities and the subsequent discussions within the ECA Air Traffic Working Group are presented in this paper. Special focus is placed on frequent flyer programmes as an integral part of loyalty programmes.

## II. Definition and characteristics of loyalty programmes

### 2.1 Definitions

5. The air travel industry offers a wide range of bonus or discount programmes under which participants are rewarded with free travel, service benefits and other privileges. In civil aviation loyalty programmes are often referred to as frequent flyer programmes or FFPs. For the purpose of this document the term **loyalty programmes** is used to indicate all measures taken by the airlines to enhance the loyalty of their customers. The most important types are frequent flyer programmes and corporate discount schemes but also travel agent commissions.
6. The term **frequent flyer programme** (FFP) is used throughout the report to denote bonus or discount programmes in civil aviation that reward frequent flyers with free travel or other benefits of a similar nature. FFPs form an integral part of loyalty programmes established by the airlines.
7. **Corporate discount schemes** (CDS) are agreements by which large airline customers are able to negotiate lower (net) fares on all or on certain parts of an airline's network.
8. **Travel agent commissions** are all payments made by airlines in return for selling airline tickets (the term does not include service fees charged to consumers by travel agencies)<sup>3</sup>. While airlines usually pay or used to pay<sup>4</sup> a set percentage fee as commission, they often enter or entered into additional agreements with certain travel agents that provide for additional rewards in certain circumstances. These are often termed travel agent commission override agreements (TACOs). As these usually provide for additional commissions for meeting certain sales targets, they may be capable of generating loyalty to the

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<sup>3</sup> The term travel agent agreements would further include more general incentive schemes and other kinds of inducements like marketing support.

<sup>4</sup> paragraph 13

airline. It is these TACOs, rather than the standard payment of a set percentage as commission, which is referred to as a loyalty programme below.

## 2.2 Characteristics

9. As in the case of most other loyalty programmes, membership of a FFP is personal and members are rewarded for using a particular product or service. As a rule, rewards can only be redeemed by the member and his/her family or in certain cases by someone accompanying the member on the journey. FFPs are open to all air travellers, including private travellers, but they specifically target business travellers. An important aspect of FFPs is that many members do not pay for their journeys themselves as they are travelling on business. Thus, points earned accrue to the business traveller personally despite the fact that it is the employer who pays for the travel.
10. While FFPs resemble other loyalty programmes in many respects, they also differ from them, primarily in the way they are designed and in the rewards they offer. As to their design, FFPs have a sophisticated points system: members of an FFP are awarded bonus points for the travel they undertake. These bonus points serve two different purposes and could be described as two different types of points. One type can be used to claim free travel, hotel accommodation, car rental, financial services or similar benefits. These points are generally valid over a long period of time. The other type can be used to upgrade passengers' service levels which entitle members to special privileges every time they fly, e.g. fast-track check-in, access to special lounges at airports, higher priority in the ticket reservation system, and seating and meal preferences on board. Service points are valid for a shorter period, usually 12 months. After that, members are required to accrue the same minimum number of points each year to keep their higher level of service.
11. Members can earn points with each flight. The points vary, depending on the destination and distance, the class and even the fare category within the class in which the person flies. Travellers earn more points on long-distance flights and flights in business class or first class than on flights over shorter distances and tourist class flights. FFPs have entry levels or thresholds which generally means that members cannot redeem and make use of the points they have earned until they have accumulated a pre-determined sum. Consequently, members may be less interested in flying with a rival airline even if that airline offers a lower price or a more suitable travel alternative.

12. In contrast with other loyalty programmes, rewards in FFPs never take the form of cash but of free services, and these do not necessarily fall into the same category as the service purchased, i.e. air travel. When threshold levels are also factored in, this use of non-monetary rewards makes it difficult to calculate and evaluate the size of the reward in relation to the total purchase value<sup>5</sup>. An additional factor in evaluating rewards is the considerable benefit to members of having access to a higher service level when a certain membership status has been achieved. Another difference compared to most other loyalty programmes is the size of the reward in relation to total purchase value. In FFPs, the reward is often higher than in other loyalty programmes and each member's total purchase value, especially in the business travel segment, is relatively high.
13. As to travel agent commissions, it is important to distinguish carefully between the types of benefits. On the one hand there are those which the agencies get, or used to automatically get from the carriers for writing out and selling tickets (3-9 % of the ticket price) for each ticket sold. On the other hand there are bonuses, which they receive periodically for the whole value of sales or the development of sales (TACOs). The latter in particular is likely to cause competition concerns if applied by dominant carriers and if constructed in a way that differs from pure quantity rebates. As a form of loyalty programme they contribute to maintaining or raising the market share of an airline. TACOs are similar to FFPs in that they use the principal-agent problem, letting passengers pay for the travel agent's reward. By making the travel agent's commission dependent of the revenue he generates for the airline, and by doing this in a non-linear way, the carrier offers a strong incentive for the agent to remain loyal to the airlines. Like with FFPs, the airline offering the largest number of destinations is likely to have the most effective override programme. Any rational travel agent would therefore stick to the TACO programme of the home carrier in his own region.
14. Hence, FFPs and TACOs are most effective for the carrier serving the largest number of destinations, and this is likely to be the national flag carrier. Apart from serving the largest number of destinations, the same carrier is also likely to serve the most destinations from its hub at a higher frequency than its competitors, although this may not be the case if the destination is a competitor's hub. Ceteris

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<sup>5</sup> The Economist (January 8th 2005, p. 14) estimates that by the end of 2004 almost 14 trillion frequent-flyer miles had been accumulated worldwide. As to their value, it stated that they are sold to credit card firms at an average of just under 2 cents a mile, and when used to buy a ticket or to upgrade to business class each mile is worth "anywhere between 1 cent and over 10 cents. Using the mid point of this range means that the global miles stock is worth over 700 billion US\$, more than all the dollar notes and coins at large."

paribus, higher frequency makes an airline more attractive to customers, since it increases their chances of departing at their desired time. This may also be a reason why travellers, especially those with high time values, are willing to pay a higher price for a flight with the national flag carrier.<sup>6</sup>

15. CDS represent another type of price discrimination as large customers use their buyer power to obtain special fare contracts with an airline, whereby a certain discount is given on every ticket bought. Often the design of the scheme isn't linear which means that the more a company uses a service of a particular airline the more it saves. CDS may require a bilateral commitment between the company and the airline e.g. the particular airline offers a discount on all or some routes operated and the company agrees to underwrite a minimum turnover.

### 2.3 Alliances and frequent flyer programmes

16. Most of the major airlines cooperate via voluntary bilateral or multilateral agreements, for example code sharing, the coordination of frequent flyer programmes or sharing facilities and services at airports. Alliances are the narrowest form of such cooperation<sup>7</sup>. They may comprise several or all of the following fields of cooperation: code sharing; coordination of frequent flyer programmes; revenue and cost sharing; joint pricing; coordination of capacities; route and schedule planning; interlining; coordination of marketing, advertising, sales and distribution networks; franchise partnership; coordination of travel agents' and other commissions; branding/co-branding; integration and development of information systems; information technologies and distribution channels; sharing of facilities and services at airports. The global alliances are illustrated by the following table:

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<sup>6</sup> Lijesen, M. G.; Rietveld, P.; Nijkamp, P. (2000): Do European carriers dominate their hubs? Tinbergen Institute Discussion Paper TI 2000-071/3. Amsterdam, Rotterdam, p. 3

<sup>7</sup> Alliances are cooperation agreements by which airlines integrate their networks and services and operate as if they were a single entity (but without the implied irreversibility of a concentration) while retaining their corporate identities (as in particular strategic alliances) and which are caught either by Article 81 (1) EC and/or Article 53 (1) of the EEA-Agreement or by the corresponding provisions in the competition laws of one or more of the national states (ECA Air Traffic Working Group (2004): Mergers and alliances in civil aviation. ERA-Forum 2/2004, pp. 297-322.).

**Tab. 1: Mayor Airline Alliances**

<b>ONEWORLD</b>	<b>SKYTEAM</b>	<b>STAR ALLIANCE</b>
Aer Lingus	Aeromexico	Air Canada
American Airlines	Air France	Air New Zealand
British Airways	Alitalia	ANA
Cathay Pacific	Continental Airlines	Austrian
Finnair	CSA Czech Airlines	Asiana Airlines
Iberia	Delta Airlines	bmi
Lan	KLM	LOT Polish Airlines
Qantas	Korean Air	Lufthansa
	Northwest Airlines	SAS
		Singapore Airlines
		Spanair
		TAP
		THAI
		United
		US Airways
		VARIG

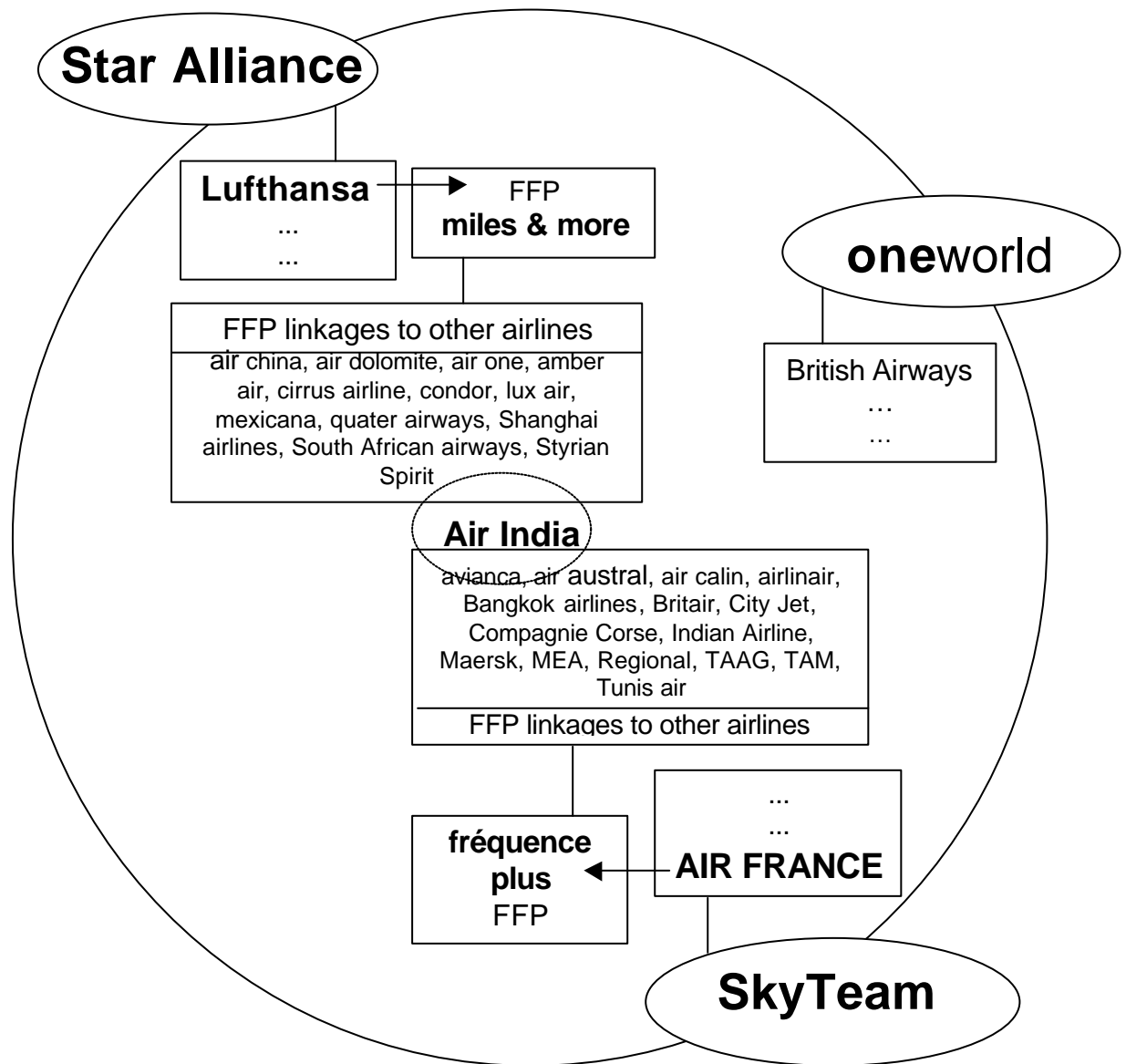
Source: The alliances' and airlines' websites by March 2005

17. Alliances usually involve FFP cooperation, either through the introduction of a joint programme or through collaboration with other programmes in the alliance. Besides such alliances, there are other types of cooperation on FFPs, especially so called "airline partnerships".<sup>8</sup> As a result of alliances and airline partnerships, members of a frequent flyer programme can earn bonus points when travelling with any of the partner airlines.
18. Membership of alliance is currently exclusive, meaning that it is not possible for an airline to join more than one alliance. This is not the case for airline partnerships. As the next figure shows, there are several linkages between airlines which belong to one, to no one or even to different alliances:

**Fig. 1: Linkages between FFP Airline Partners within alliances**

<sup>8</sup> Moreover, airlines sometimes collaborate with other types of undertakings, such as hotel enterprises, car rental firms or finance corporations, primarily credit card companies. All of these, on their part, cooperate with numerous airlines and alliances.





Source: The alliances' and airlines' websites by March 2005

19. Here Air India, which is not a member of one of the global alliances, is an airline partner of Lufthansa's (Star Alliance member) FFP "miles & fly" as well as an airline partner of Air France's (SkyTeam) FFP "fréquence plus". Other examples of linkages which are not represented are those between the FFPs of

- US Airways (star alliance) and Qantas (oneworld)
- Singapore Airlines (star alliance) and delta airlines (Sky Team)
- Alitalia (Sky Team) and Qantas (oneworld).

### III. Legal Background

#### 3.1 Art. 81 and 82 of the EC Treaty<sup>9</sup>

20. Neither national nor European competition laws provide specific rules for loyalty programmes. In certain circumstances, loyalty programmes can amount to an abuse of a dominant position under Art. 82.<sup>10</sup> According to established case law dominance is defined as follows: the dominant position referred to in Art. 82 relates to a position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained on the relevant market by giving it the power to behave to an appreciable extent independently of its competitors, of its customers and ultimately of its consumers.<sup>11</sup>
21. Although ECA's case law is based mainly on Art. 82 the assessment of loyalty programmes in the light of Art. 81 is not ex ante excluded. As will be seen in chapter 4.1, Art. 82 is not always interpreted by the competition authorities in Europe with regard to loyalty issues in a similar manner. In the future, proceedings based on Art. 81, which is not related to the holding of a dominant position in a market, may gain importance because of decreasing market shares of several national flag carriers.
22. So far, no case concerning airline FFPs has been tried by The European Court of Justice (ECJ). However, on one occasion the CFI<sup>12</sup> dealt with travel agency commissions (cp. chapter 4.1.1, para 34) and the ECJ has on several occasions

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<sup>9</sup> Id. Art. 53, 54 EEA agreement in the whole chapter.

<sup>8</sup> Article 82: "Any abuse by one or more undertakings of a dominant position within the common market or in a substantial part of it shall be prohibited as incompatible with the common market insofar as it may affect trade between Member States.

Such abuse may, in particular, consist in:

- (a) directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions;
- (b) limiting production, markets or technical development to the prejudice of consumers;
- (c) applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;
- (d) making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts."

<sup>11</sup> Case T-128/98 *Aéroports de Paris v. Commission* [2000] ECR II-3929, paragraph 147.

<sup>12</sup> Judgment of the Court of First Instance (First Chamber) of 17 December 2003. *British Airways plc v Commission of the European Communities*. Competition - Case T-219/99.

dealt with loyalty rebates<sup>13</sup>. To reach a general understanding of the underlying “thinking” regarding the prohibition of certain “incentive schemes” the case law of the ECJ on loyalty programmes is summarized.

23. In its ruling in the *Hoffmann-La Roche Case*<sup>14</sup> the ECJ stated that if an undertaking which is in a dominant position in a market ties purchasers by an obligation to obtain all or most of their requirements exclusively from the said undertaking, it abuses its dominant position. Furthermore, the ECJ stated that “obligations of this kind to obtain supplies exclusively from a particular undertaking [...] are incompatible with the objective of undistorted competition within the common market, because [...] they are not based on an economic transaction which justifies this burden or benefit but are designed to deprive the purchaser of or restrict his possible choices of sources of supply and to deny other producers access to the market”
24. FFPs do not formally demand exclusivity in the same way as the fidelity rebates in the *Hoffmann-La Roche Case*. The effect of the FFPs is more akin to the target rebate system that was considered in both *Michelin* judgments<sup>15</sup>. The same reasoning has been applied to rebate systems, e.g. loyalty programmes by the Court of First Instance (CFI). In its *British Airways* ruling<sup>16</sup> the CFI stated: “Concerning more particularly the granting of a rebate by an undertaking in a dominant position, consistent case law shows that a fidelity rebate, granted in consideration of an undertaking by the customer to take supplies exclusively or almost exclusively from a dominant undertaking, is contrary to Art. 82. Such a rebate has the effect, through the granting of financial advantages, of preventing customers from obtaining supplies from rival producers. “
25. More generally, a system of rebates, which has the effect of preventing customers from obtaining supplies from market competitors, will be regarded as contrary to Art. 82 if it is applied by an undertaking in a dominant position. For that reason, the ECJ has held that a rebate linked to the attainment of a

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<sup>13</sup> Joined Cases 40/73 to 48/73, 50/73, 54/73 to 56/73, 111/73, 113/73 and 114/73 *Suiker Unie and Others v Commission* [1975] ECR 1663, paragraph 518; *Hoffmann-La Roche*, cited in paragraph 182 above, at paragraphs 89 and 90; *Michelin*, cited in paragraph 91 above, at paragraph 71, and *BPB Industries and British Gypsum*, paragraph 120.

<sup>14</sup> Case 85/76 *Hoffmann-La Roche v. Commission* [1979] ECR 46.

<sup>15</sup> Case 322/81 *Michelin v. Commission* [1983] ECR 3461 [*Michelin I*]; Judgment of the Court of First Instance (Third Chamber) of 30 September 2003: *Michelin v. Commission - Case T-203/01* [*Michelin II*].

<sup>16</sup> Judgment of the Court of First Instance (First Chamber) of 17 December 2003: *British Airways plc v Commission of the European Communities. Competition - Case T-219/99*.

purchasing objective also infringed Art. 82 (Michelin I, paragraph 86).<sup>17</sup> Thus to apply the case law from the judgments in Michelin I and II, and the British Airways<sup>18</sup> one would have to claim that the concerned airline holds a dominant position in the relevant market.

### 3.2 Provisions of national competition laws

26. Each of the national competition laws provides provisions with respect to abusive behaviour by undertakings. The powers to prohibit such behaviour are laid down in the following provisions of the national jurisdictions:

- Austria: Sec. 35 of the Cartel Act,
- Denmark: Art. 11 (4) and Art. 16 of the Danish Competition Act,
- Estonia: Art. 16 of the Estonian Competition Act,
- Finland: Art. 6 of the Finnish Competition Act,
- France: Art. L. 420 – 2 of the Code of Commerce,
- Germany: Sec. 19, 20 of the Act Against Restraints of Competition (GWB),
- Greece: Art. 2 of Law 703/77, which has practically the same wording as Art. 82 of the EC Treaty,
- Hungary: Chapter V on the prohibition of abuse of a dominant position of the 1996 Act LVII on the prohibition of unfair and restrictive market practises,
- Italy: Art. 3 of the Italian Law 287/90, which has practically the same wording as Art. 82 of the EC Treaty,
- Ireland: Section 5 of the Competition Act 2002,
- Latvia: Sec. 13 of the Latvian Competition Act,
- Lithuania: Sec. 9 of the Lithuanian Competition Act,
- Netherlands: Art. 24 of the Competition Act,
- Norway: Sec.11 of the Norwegian Competition Act,
- Poland: Art. 8, para 2 of the Act on competition and consumer protection,

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<sup>17</sup> British Airways, cited above, at paragraphs 244 and 245.

<sup>18</sup> These decisions have been subject to a lot of debates.

- Slovak Republic: Art. 8 of Act. No. 136/2001 Coll. on the Protection of Economic Competition,
- Spain: Sec. 6 of the Spanish Competition Act,
- Sweden Sec. 19 of the Competition Act,
- UK: S. 18 of the Competition Act 1998.

27. The following section gives examples of how these national provisions and Art. 82 have been applied by national competition authorities to examine or prohibit certain conduct with regard to loyalty programmes.

## IV. Competition Assessment

### 4.1 Competition case law from around Europe<sup>19</sup>

28. Eight competition authorities have conducted formal investigations in relation to loyalty programmes in the field of air transport (in particular corporate discount schemes or travel agents agreements/commissions) in the last five years (Finland, Germany, Ireland, Italy, Spain, Norway, Sweden and the European Commission). Only the Swedish and the Norwegian competition authorities have intervened against loyalty programmes in relation to FFPs. The European Commission tends not to prohibit FFPs but to open them up to other airlines. Several other competition authorities dealt with travel agents agreements or commissions which were not loyalty inducing. For example the competition authorities of UK, Ireland, Germany and Austria have studied the reduction/abolishment of travel agent commissions. Some other national competition authorities have dealt with these issues without opening formal investigations in terms of studies or as peripheral issues of broader cases.

#### 4.1.1 Travel agent commissions

29. Travel agent commissions might act as an incentive to work hard at selling airline tickets. However, applied in certain ways (e.g. TACOs) they represent a strong incentive to sell tickets exclusively from a particular airline – usually the national flag carrier – thus making it difficult for other airlines to sell their tickets. TACOs are equivalent to a “loyalty discount” meaning a discount based not on cost savings but on loyalty, which has been consistently condemned as an exclusionary abuse of a dominant position in the past. A dominant firm should

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<sup>19</sup> As of 1<sup>st</sup> March 2005.

only provide supplementary commissions to travel agents where these reflect extra services provided by the agent or efficiencies realised. Despite alternative means becoming available travel agents remain the most significant method used by airlines to sell air transport. Given this, there have been various cases where national competition authorities (Finland, Norway, Italy, Spain) and the Commission started investigations or even prohibited certain reward schemes (TACO's):

30. The Finnish Competition Authority has been examining the travel agency commissions of the national flag carrier Finnair. Their preliminary analysis led the Finnish Competition Authority to the conclusion that some of the elements included in the travel agency commissions were likely to be loyalty creating or binding in relation to competition law. The FCA took the view that Finnair dominates both the domestic route network and the international scheduled air transport. The FCA also considered that the criteria applied by Finnair, when negotiating both travel agency and corporate customer agreements, were not as transparent as legislation would require. The FCA sent Finnair a statement of objections and has received the company's response. The case is still ongoing.
31. In 2004 the Norwegian Competition Authority assessed the travel agency agreements of SAS. Nothing illegal was found in the agreements as such. However, there is a problem with transparency as these agreements are renegotiated regularly. In these negotiations the airlines have both the possibility and an incentive to reward loyalty and punish disloyalty on the part of the travel agencies.
32. In June 2001 the Italian Competition Authority concluded an inquiry under Art. 82 into certain practices of Alitalia Spa<sup>20</sup>. They found that Alitalia was the dominant buyer in the market for air transport travel agency services. They also noted that no travel agent could realistically consider not supplying its airline ticketing services to Alitalia without incurring an irreparable loss and that this allowed Alitalia to act independently of other airlines in purchasing travel agents' airline ticketing services. With regard to abusive behaviour, the Italian Competition Authority first ascertained that the incentive schemes for travel agents amounted to target loyalty rebates. They also found that the incentive schemes did not relate the size of the commission to the volume of travel agents' ticket sales in absolute terms but to the increase in their sales with respect to the previous year. In this way commissions were linked to travel agents' loyalty rather than to

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[http://www.agcm.it/agcm\\_ita/DSAP/DSAP\\_287.NSF/82c404970a1b0866c12564ac004c69c9/c9881731d4e53115c125692000532dea?OpenDocument](http://www.agcm.it/agcm_ita/DSAP/DSAP_287.NSF/82c404970a1b0866c12564ac004c69c9/c9881731d4e53115c125692000532dea?OpenDocument)

efficiency gains achieved by Alitalia. This meant that each travel agent had a strong incentive not only to maintain its previous year's volume of Alitalia ticket sales but also to increase that volume to the extent requested by Alitalia. In the light of the foregoing the Italian Competition Authority deemed that the incentive schemes adopted by Alitalia constituted an abuse of a dominant position insofar as they were likely to produce a strong loyalty creating effect on travel agents and thus to obstruct the activity of competing carriers in the market. The Italian Competition Authority also deemed that the incentive schemes adopted by Alitalia constituted abusive practices within the meaning of Art. 82 because they permitted the application of dissimilar conditions to equivalent transactions and discriminated between travel agents. In particular, by ignoring the volume of tickets sold in absolute terms, those incentive schemes produced different revenues for travel agents that sold the same quantity of tickets when the quantities sold in the previous year were different.

33. The Spanish Competition Court or Tribunal de Competencia (TDC) considered that the Spanish airline Iberia infringed Art. 6 of the Spanish Competition Act by setting up a loyalty programme in the market for domestic flights<sup>21</sup>. The loyalty programme consisted of a variable and substantial incentive bonus called "Creciberia" that Iberia applied when the annual turnover of Iberia tickets of the travel agencies surpassed 3% over the precedent year. The TDC concluded that Iberia maintains a position of dominance in the domestic air traffic market, where it holds a 60% share of the market. In addition, the competition is very weak, as shown by the high percentage of slots held by Iberia at the main airports. Because the air tickets are the main input in the travel agency business the Court considered both markets as interrelated (air traffic and air traffic tickets mediation); thus, Iberia's position of dominance in the air traffic market translates to the air tickets mediation market, where Iberia holds a position of dominance as well. In this situation the travel agencies have an attractive incentive to channel their clients to the Iberia company, even keeping silent about alternative offers from other companies. In this context the incentive bonus "Creciberia" makes it difficult for the new entrants in the market to capture market share, which perpetuates the position of dominance of Iberia in the air traffic market in infringement of Art. 6 of the Spanish Competition Act.

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The case can be viewed in two steps: i) Go to the web address <http://www.tdcompetencia.org/frames.asp?menu=5> and then ii) click on the first line: 514/01 IBERIA 01/04/2002.

34. The European Commission has dealt with loyalty incentives in the market of travel agency services, too<sup>22</sup>. The case arose from a complaint made by Virgin against the system of commissions for UK travel agents paid by British Airways (BA). Acting upon this complaint the European Commission investigated BA's incentive schemes. In July 1999 this investigation resulted in the adoption of a decision with fines concluding that the incentive schemes BA had operated for UK travel agents were in breach of Art. 82. Following the decision, BA adopted a new scheme consisting of two main elements, a flat rate booking fee and sales-marketing agreements that reward travel agents for meeting certain quality targets. Nevertheless, BA appealed against the decision before the CFI. The CFI delivered its judgment on 17 December 2003 and confirmed the decision on all counts.<sup>23</sup> BA appealed to the ECJ. The appeal is pending.
35. The contested BA schemes displayed two features: (1) the rebates were calculated on the increase of sales realised by each travel agent during the reference period compared with the previous reference period; and (2) once the threshold for receiving the rebate was exceeded, the rebate was granted for all tickets sold during the reference period, including those below the threshold. On this basis the European Commission concluded that once a travel agent is close to reaching a sales target, meaning that he will receive a higher commission rate, he is unlikely to promote tickets of airlines other than BA as he will not only lose the higher commission on the incremental sales but on all BA sales he made during the reference period.
36. The European Commission also took the necessary measures to ensure that the afore-mentioned principles were applied to other EU airlines in equivalent situations. In the context of the European Commission's investigation into its incentive schemes for UK travel agents, BA lodged complaints against eight other EU carriers<sup>24</sup>, claiming that their incentive agreements included features to which the European Commission objected as in their decision in *BA*. In addition to its investigations into the complaints lodged by BA, the European Commission opened three ex-officio proceedings and investigated all the various incentive schemes operated by these carriers. In cases where the European Commission raised doubts about the conformity of the schemes operated by the airlines, the

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<sup>22</sup> <http://curia.eu.int/jurisp/cgi-bin/form.pl?lang=en&Submit=Submit&docj=docj&numaff=T-219%2F99&datefs=&datefe=&nomusuel=&domaine=&mots=&resmax=100>

<sup>23</sup> Judgment of the Court of First Instance (First Chamber) of 17 December 2003. *British Airways plc v Commission of the European Communities*. Competition - Case T-219/99.

<sup>24</sup> Sabena, Alitalia, Olympic Airways, Lufthansa, Air France, Austrian Airlines, KLM and SAS. See Competition Policy Newsletter (2003), No. 2, Summer, p. 65-67.



airlines concerned undertook gradual reforms of their incentive schemes with travel agents (Air France, Lufthansa, Austrian Airlines). As a result, between June and December 2002, the European Commission was able to inform BA that it considered the individual incentive schemes operated by the abovementioned airlines to be compatible with Art. 82. As BA didn't submit further observations, the European Commission subsequently closed these investigations.

37. In the last few years a growing number of airlines have begun to reduce their travel agent commissions significantly or to even abolish them. Instead the airlines moved to a system of net prices. This means that the travel agencies pay a fixed price for the ticket and that they must set a margin on top of that when reselling them to travellers in order to cover costs and make a profit. Some travel agencies have opposed this system as it enhances competition between them. National competition authorities such as the OFT (UK), the Irish Competition Authority, the Bundeskartellamt (DE) and the Bundeswettbewerbsbehörde (AT) have considered these processes mainly as a possible abuse of a dominant position. However, all of them came to the conclusion that the reduction or abolishment of travel agent commissions does not infringe Art. 82 or the respective national provision.
38. As an example, the Irish Competition Authority investigated claims that the reduction in commissions to travel agents from 9% to 5% by Aer Lingus was an abuse of a dominant position. It was not clear that Aer Lingus plc was dominant in the market for air travel agency services in the Member State. Even if it were dominant, insufficient evidence was presented to show that Aer Lingus commission levels were excessively low or that the predicted reduction in travel agency numbers would lead to a decline in competition. Travel agents have the alternative of charging a fee for the service that they provide, while there is an increasing number of sources of information about air travel and fares. Finally, the conduct of Aer Lingus represents a move to a different business model as the result of industry changes. As such it has an objective justification.<sup>25</sup>
39. In another example, the Austrian Cartel Court examined whether travel agencies are considered non-genuine agents and if so, whether abolishing the travel agent

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The decision may be found on the Irish Competition Authority's website at: [www.tca.ie/decisions/enforcement/e\\_02\\_001.pdf](http://www.tca.ie/decisions/enforcement/e_02_001.pdf). It should be noted that unlike many other national competition authorities the Irish Competition Authority does not have the power to make decisions finding a breach of competition law; that is a function of the courts. However, the Authority as an investigative body can come to a view that the facts in a particular case do not, in its opinion, breach competition law. In such cases the Authority may decide to publish a reasoned decision. The Authority's opinion that there had not been a breach of competition law in this particular case was based on Irish competition law.

commission while keeping the obligation to print the net price on the ticket would infringe Art. 81 in the form of retail price maintenance. In January 2005 the Austrian Cartel Court decided in favour of the airline: the system does not constitute a retail price maintenance infringing Art. 81 as the travel contract is concluded directly between the airline and the final customer. The travel agency is only executing a declaration of interest to buy a ticket on behalf of the final customer. The price for the travel contract between airline and customer is fixed by the airline. The price for the additional service contract between travel agency and customer is fixed by the travel agency and does therefore not restrict it in its competitive behaviour. Furthermore, the Austrian Cartel Court considered a travel agency neither a genuine nor a non-genuine agent, as it is not acting on behalf of the airline. The travel agencies have appealed against the Austrian Cartel Court's decision, and so the case is ongoing.

#### **4.1.2 Corporate discount schemes**

40. Corporate discount schemes are agreements by which customers of an airline (usually the national flag carrier) are able to negotiate lower (net) fares on all of or on certain parts of an airline's network. The preferred airline will be the one who operates the most flights to important destinations.
41. From a competition angle, corporate discount schemes have ambiguous effects. On the one hand, they reflect a certain transfer of market power from the seller to the buyer. As such, they can be viewed as sound examples of enhanced competition. However, many of these deals take forms that engender important lock-in effects, as when the rebate is somehow progressive, i.e. the percentage discount given depends on the total volume of sales through a certain period of time on a certain air travel network. Such agreements provide an incentive for the buyer to concentrate his demand to one or a few carriers. Larger carriers will obtain an inherent advantage compared to smaller ones. Such corporate discount schemes have, in other words, clear anti-competitive effects.
42. Corporate discounts may conceivably have the effect of raising the price for all those companies that do not benefit from them. Interestingly, there are even indications that corporate discount schemes may lead to higher nominal fares in a duopoly situation than in a comparable monopoly setting. This is so because the duopoly will put pressure on the percentage discount. To compensate for this, airlines may want to increase their nominal fares. A monopoly airline, on the

other hand, has a much stronger negotiating position and need not agree to large discounts in order to keep its largest corporate clients.<sup>26</sup>

43. The Finnish and the Norwegian competition authorities have conducted formal investigations with regard to corporate discount schemes. The Finnish Competition Authority has been examining the corporate discount schemes of the national flag carrier Finnair. The Norwegian Competition Authority intervened against the SAS Group's corporate discount schemes in December 2003. The intervention amounts to a ban on progressive volume rebates and use of clauses stating that the SAS Group is to be given preference over other airlines. In addition the SAS Group must use a clause stating that the customer is free to choose other airlines. The decision has been appealed to the Ministry of Labour and Government Administration. At the moment, probably no illegal clauses in the corporate agreements will be found again. However, the transparency related to renegotiations is an issue here as well (see above 4.1.1). Furthermore the combined effect of FFPs and CDSs especially in the business traveller segment might have to be examined in depth. This may lead to discriminatory behaviour, as there are different kinds of CDS, ranging from negotiated fares for every city-pair to total purchase bonuses. If an important segment of the market is absorbed in this way, the activities of competing airlines will be made difficult. Besides this it is not always easy to assess whether corporate discounts may not be due to market dominance or at least the market power of the benefited enterprises.
44. After an intervention of the German competition authority, Lufthansa modified its bonus programme for major customers as this constituted an unfair hindrance of competitors within the meaning of Section 20 (1) Act against Restraints of Competition (ARC). At the time, the bonus programme granted major customers a 20 per cent discount which they could take advantage of by purchasing quarterly or annual coupon pads and sticking the coupons on to their respective flight tickets. A particularly decisive factor was the fact that customers did not have the possibility right from the start to opt to purchase a smaller number of Lufthansa flights at a considerably lower discount rate; this significantly restricted their possibilities to purchase and make use of other competitors' major customer bonus programmes. In a civil cartel procedure, the Higher Regional Court<sup>27</sup>

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<sup>26</sup> Nordic competition authorities (eds.) (2002): Competitive Airlines. Towards a more vigorous competition policy in relation to the air travel market. Report from the Nordic competition authorities, No. 1/2002, pp. 9-10.

<sup>27</sup> WuW/E OLG 4601-4611.

stated that Lufthansa's bonus programme of progressive nature created excessively strong customer ties to Lufthansa, which exceeded the level of customer baiting, usually connected with a quantity discount. This therefore represented an unfair hindrance of Lufthansa's competitors.

#### 4.1.3 Frequent flyer programmes

45. Up until now, only the Swedish and the Norwegian competition authorities have intervened against loyalty programmes in relation to FFPs. Scandinavia has taken a more critical stance towards FFPs. The Swedish Competition Authority (SCA) considered the SAS EuroBonus scheme<sup>28</sup>. The SCA found that SAS had abused its dominant position by applying its EuroBonus programme for domestic flights, as this made it harder for other carriers to start or to maintain competitive services on domestic routes. The SCA's decision meant that SAS was no longer permitted to operate its FFP in such a way that points or the equivalent for the redemption of bonus awards could be earned on domestic flights. SAS appealed the decision to the Market Court. In its ruling<sup>29</sup> of 27 February 2001, the Swedish Market Court ordered SAS to cease applying its EuroBonus FFP in such a way that domestic travellers could earn points or the equivalent for the redemption of bonus awards on routes where SAS was in competition with other carriers. The ruling applies to domestic air travel in Sweden between cities where SAS, or airlines cooperating with SAS on the scheme, encounter competition through existing or newly established scheduled air passenger traffic.
46. The practice was deemed to be an abuse of SAS's dominant position in breach of Section 19 of the Swedish Competition Act. The Market Court decision did not, however, prevent SAS from applying its EuroBonus programme on domestic flights where it is the only operator. The Market Court stated, when delivering its opinion, that frequent flyer programmes unquestionably had a loyalty-inducing effect as their very purpose was to give travellers an incentive to use the services of the company concerned. FFPs may distort market incentives, particularly when the person travelling is not the one who is paying. The Market Court stated further that the EuroBonus scheme's loyalty-inducing effect could be intended as a means of influencing price formation by reducing customers' sensitivity to price. It also noted that the application of the programme had a price-raising effect, although this could not be calculated in precise terms.

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<sup>28</sup> The case can be found at <http://www.kkv.se/beslut/98-0920.htm> (only available in Swedish).

<sup>29</sup> The ruling can be found at <http://www.marknadsdomstolen.se/avgoranden2001/Dom01.4.PDF> (only available in Swedish).

47. On 18 March 2002, the Norwegian Competition Authority ordered the SAS air carrier group to stop awarding frequent flyer points on domestic Norwegian routes. Unlike the Swedish ruling, the prohibition in Norway applies on all domestic routes, competitive or not. It became effective on 1 August 2002. The appeal filed by SAS was turned down by the court of appeal, the Norwegian Ministry of Labour and Government Administration.
48. The Norwegian Competition Authority considered that such an all-out ban might be necessary in order to dismantle the barriers to entry and reopen the market for competition. Although the relevant markets consist of single city pairs, a ban affecting only certain routes would, on account of the important network economic effects at play, still mean that the dominant network airline would retain an important competitive advantage, even on the routes affected by a bonus collection ban. Moreover, a ban affecting only certain selected routes, and this contingent upon the entry of some second carrier, might not convey a sufficiently unequivocal and transparent message to both sides of the market – travellers and potential new entrants alike.
49. The intervention by the Norwegian Competition Authority appears to have been effective. Only one month after the ban on frequent flyer point collection took effect, a new entrant opened services on the four major domestic routes. As of January 2004, this competing carrier operates 12 domestic routes and five international ones. It has a domestic market share of approximately 20%.
50. The European Commission has dealt with FFPs in four cases concerning cooperation between airline companies in alliances. As a feature of their alliance agreements, the airline companies allowed the alliance partner's clients to collect and use accumulated points in each other's FFPs. In the SAS/Lufthansa case, the European Commission stated that the cooperation between the two companies on FFPs was likely to be a not inconsiderable barrier to market entry, and therefore a breach of Art. 81(1). The European Commission's condition for approval under Art. 81(3) was that any other airline which provided or wished to provide services on the routes in question and which did not have a FFP applicable at the international level, should be afforded the opportunity of participating in the programme.

#### **4.2 Possible criteria for qualifying loyalty programmes as abusive**

51. Answering an ECA questionnaire, thirteen competition authorities presented criteria, which have been or should be considered when qualifying a loyalty programme as abusive (Denmark, Finland, France, Germany, Greece, Italy,

Norway, Poland, Spain, Sweden, UK, European Commission and EFTA). It was stressed that the effects of a loyalty programme will generally have to be evaluated on a case-by-case basis. The answers were given to a separate question considering potential abusiveness criteria so that the considered criteria do not necessary follow from the above-mentioned case law. They may refer to economic theory, case law in other branches, competition law, guidelines or other sources. Following the answers, a loyalty programme may – case-by-case – be considered as abusive if it has tying effects, foreclosure effects, strong loyalty effects, strong exclusivity effects or if they are able to reduce or eliminate effective or potential competition.

52. Tying exists when the supplier makes the sale of one product conditional upon the purchase of another distinct product from the supplier or someone designated by the latter (often known as a positive tie), or at least conditional upon the customer agreeing he will not purchase that product from any other supplier (often known as a negative tie) regardless of whether he or she may or may not want. If the tying is not objectively justified by the nature of the products or commercial usage, such practice may constitute an abuse of a dominant position. Agreements of this type, which are designed to make the sale of one product conditional upon the purchase of another distinct product, may be incompatible with the competition rules.
53. Foreclosure can be defined as the absence, due to the agreements of real and concrete possibilities of gaining access to a market. Agreements normally only create significant barriers to entry when they cover a significant proportion of the market<sup>30</sup>. In other words, a foreclosure effect arises from agreements, which are capable of affecting patterns of trade making it more difficult for undertakings to penetrate a market. It may occur when suppliers impose exclusive purchasing obligation on buyers.
54. Exclusivity effects arise when there is only one buyer to which a supplier may sell a particular final product. For intermediate goods or services, exclusive supply is often referred to as industrial supply. In an exclusive customer allocation agreement, the supplier agrees to sell his products only to one distributor for resale to a particular class of customer. At the same time, the distributor is usually limited in his active selling into other exclusively allocated classes of customer. The possible competition risks are mainly reduced intra-brand competition and market partitioning, which may in particular facilitate price

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Assuming that the contracts are not contestable when made.

discrimination. When most or all of the suppliers apply exclusive customer allocation, this may facilitate collusion, both at the suppliers' and the distributors' level. Hence, a competition risk of exclusive supply is the foreclosure of other buyers.

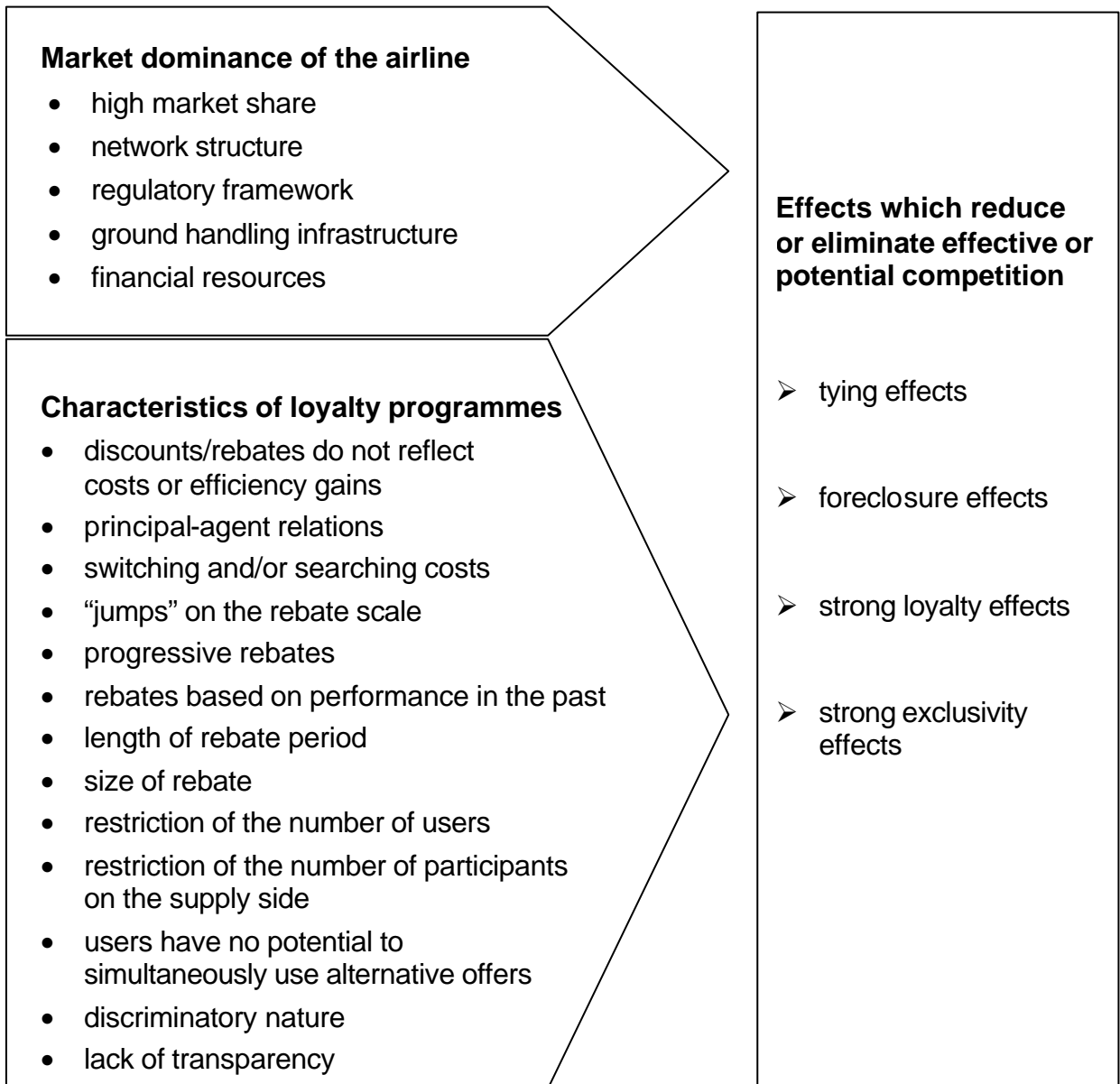
55. A loyalty effect results from measures, which try to influence the consumers' behaviour.<sup>31</sup> Often a partnership is established on the basis that the sellers' profit is split with those who create it, the customers. However, customers may in addition be behaviourally loyal because of convenience, accessibility, lack of choice, high search and evaluation costs or high switching costs<sup>32</sup>. Thus the strength of an enterprise's loyalty inducing measure depends on other parameters or circumstances.
56. The subsequent figure summarises the effects on the right side and the typical characteristics on the left. These can help to make operational the critical effects of loyalty programmes. They are not attributed to a specific effect on the right side, although all of them contribute to indicating when loyalty programmes may be considered abusive.

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<sup>31</sup> Reichheld, F. (1996): *The Loyalty Effect*. Harvard Business School Press.

<sup>32</sup> Which can, of course, be actively influenced by the seller's behaviour, too.

**Fig. 2: Possible criteria for abusive loyalty programmes**



Source: Synopsis of the answers of 13 ECA members.



## V. Economic topics concerning FFPs

### 5.1 General remarks

57. Airlines compete in areas such as price, service levels, flights and frequent flyer programmes. The main aim of a FFP for the airline is to induce customer loyalty. From an economic viewpoint, a FFP may be compared to a consumption option that is redeemable given a certain range or number of events occurring at a future date, i.e. a sufficient number of bonus points must be earned by means of certain actions. When further bonus points are earned, the requirement whereby certain events must occur for the option to be redeemed is moderated. For instance, in terms of economic utility theory, bonus points give travellers greater benefit e.g. in the form of free travel at a future date. The extent to which bonus points affect a traveller's benefit depends on the person's marginal valuation of various consumption alternatives and on the alternatives to which the traveller expects to be given access.

### 5.2 Switching costs

58. The costs to the traveller of switching from one airline company to another are called switching costs. The amount of these costs depends on a number of factors, such as the absolute and relative size of the carrier, the number of its departures, number of departures among its competitors, the geographical location of airports used by the various carriers, and the presence of FFPs. The latter contribute to switching costs by giving customers a stronger incentive to use the same airline company again, which raises the cost to the customer of switching companies. It also reduces competitors' chances of attracting customers away from that airline. At the same time, competitors find it harder to attract customers from the airline concerned.

59. Following theoretical models<sup>33</sup>, switching costs can result in substantial welfare losses in the form of lower production and consumption levels and higher prices. These costs may also represent a barrier to market entry and thus limit competition (see also next chapter). The model outcome suggests that government authorities should combat activities that increase travellers' switching costs such as loyalty programmes and FFPs.

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<sup>33</sup> See for example Klemperer, P. (1995): Competition when consumers have switching costs: An overview with applications to industrial organization, macroeconomics and international trade. In: Review of Economic Studies 62, pp. 515-539.

60. Switching costs in the air travel market apply both to prices and number of passengers, which means that to some extent such costs may be viewed as adversely related to consumer welfare. Increased switching cost would in that case correspond to a decline in consumer welfare. It should be noted here that while travellers who do not switch to another airline are not directly affected by switching costs, they are affected indirectly, as prices are likely to increase when switching costs increase.

### 5.3 Barriers to entry

61. A FFP can limit competition by reducing the number of airlines active in the market. In addition, it can impede the entry of market newcomers, as the presence of such a programme may reasonably cause an airline considering entry into the market to decide that such a move would be unprofitable. For example, assume two undertakings have identical structures but the incumbent airline's customers have already accrued bonus points. They would incur a cost by choosing to travel with the newcomer. If the incumbent airline sets the prices so low that the 'normal' profit is zero, the airline considering market entry must, due to the switching cost, set prices even lower in order to attract customers. If both airlines have the same level of production costs, either the newcomer will make a loss or no customer will seek its services, which means entry is likely to be unprofitable.<sup>34</sup> In other words, if incumbent carriers have been able to recruit a large part of the potential clientele into their frequent flyer programmes, a new entrant may find it exceedingly difficult to capture an economically viable market share. This deterrent effect on entry is reinforced if an incumbent company is large (dominant) and has numerous members in its FFP. A company considering entry into such a market must be prepared either to offer a substantially better FFP, a better quality of services or markedly lower prices.
62. Alliance airlines (cp. chapter 2.3) join their FFPs to offer attractive, extended networks to travellers seeking to claim bonus points. Smaller airlines or alliances have a distinct competitive disadvantage. The FFPs may thus strengthen any dominant position and reinforce the possible anti-competitive effects of large hub-and-spoke networks. This applies primarily to business travellers seeking to get low cost fares. The situation in the Norway up until autumn 2002 suggests that the incumbent had increasing success while the newcomers' success was limited. Nonetheless, new airlines do exercise a pressure on incumbents. This

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<sup>34</sup> Cp. Cairns, R.; Galbraith, J. W. (1990): Artificial compatibility, barriers to entry and frequent-flyer programmes. In: Canadian Journal of Economics 23, pp. 807-816.,

refers to both the business and the leisure segment. Smaller specialised airlines compete in the business segment and low cost airlines gather market shares from the incumbents even in both segments. On some routes, German low cost airlines “Germanwings” or “Air Berlin”, for example, are said to sell up to 40% of their tickets to persons travelling for business purposes. In its recent Lufthansa/Swiss case (COMP/M.3770), the European Commission found a low-cost share of about 10% within the business segment.<sup>35</sup>

63. In particular, there is reason to be aware of the anti-competitive effects in a setting with one (or a few) established firm(s) and a potential entrant. In cases where a FFP is used by an airline that is dominant in a market, the programme may represent a barrier to market entry as a result of travellers tending to join a programme that offers the highest number of departures and the largest network of routes. In some markets, this may lead to an absence of suitable bonus alternatives for the traveller. Alliances and other forms of collaboration – with airlines and other types of undertakings – tend to reinforce this market dominance, which in turn strengthens the entry barriers that FFPs represent.

#### 5.4 Principal-agent problem

64. FFPs can give rise to certain economic efficiency losses in the market due to distorted incentives in a “principal-agent” situation. This may particularly be the case if the person who uses a service is not the one who pays for it. The incentives faced by the FFP member, i.e. the “agent”, are different from those faced by the employer, i.e. the “principal”. An employee on a business trip may decide to choose the more expensive of two carriers even if the difference in quality between the services provided by the two companies does not justify such a choice.
65. Most business travellers do not pay for their air travel themselves. A lower ticket price reduces the costs to the employer but normally doesn’t result in any direct advantage to the traveller. The effects that a loyalty programme can have may be simply described in the following terms: If a traveller is to undertake a journey and the private utility ( $u$ ) of flying with company A (expressed as  $u_A$ ) is greater than the utility of flying with company B (expressed as  $u_B$ ), the traveller chooses company A regardless of the price as it is the employer who pays for the trip, given that the traveller does not take the cost to the employer into consideration. A loyalty programme will change the decision criteria as the traveller then also

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Differences may be due to different definitions of the business segment: whereas the Commission focuses on time sensitivity, the Airlines may have referred to invoice recipients.

considers the additional utility that further bonus points would entail. This additional utility is designated  $a$  for a journey with company A and  $\beta$  for a journey with company B. The decision criterion for the traveller is that he/she chooses company A if  $u_A + a > u_B + \beta$ . This means that a traveller can choose a less comfortable journey if the bonus points are considered to offset the loss in comfort. There is also reason to note that the incentive to undertake travel that is wholly or partially unnecessary increases in the presence of a FFP for travellers who only consider their own interests.

66. The private use of bonus points earned through business travel is taxable in many countries. In practice, however, it is difficult to enforce this tax rule, since the tax authorities have insufficient verification data at their disposal. This may accentuate the efficiency loss due to the afore-mentioned principal-agent structure.

### 5.5 Other implications

67. FFPs mean costs to the airlines, be they administrative ones or (if all the seats would have been booked anyway) opportunity costs. At the same time willingness to pay for travel with a company operating a FFP can be expected to increase and, all else equal, the company can charge a higher price for its flights. It can also reduce the number of departures as willingness to fly with the company has increased. Rival carriers have the incentive to respond to the competitive advantage that a FFP represents by introducing price cuts, increasing their number of departures, raising the quality of their product range, or by other means. How great the effects will be depends on factors such as the extent to which the services of the various carriers are perceived to be interchangeable by the customer and how price-sensitive the customer is.
68. Different categories of customers may be more or less price-sensitive. Undertakings, for instance may be considered as less price-sensitive, i.e. show greater willingness to pay, than private travellers.<sup>36</sup> If this is the case, the impact on price is greater in the business traveller category than in the private traveller category.
69. If the services of the various carriers are roughly on a par, the impact on competitive prices will be considerable. If the companies' products are close substitutes, the impact on competitors' prices will be considerable. The more

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<sup>36</sup> Cp. Oum, T.H.; Yu, C. (1992) Economic Efficiency of Passenger Railway Systems and Implications for Public Policy. Canadian Transportation Research Forum 27.

price-sensitive a customer is, the less the impact will be on price. It is reasonable to assume that two companies operating from the same airport and on the same route will be more closely substitutable than two companies operating from different airports on the same route, i.e. the impact on competitors' prices in the latter example will be more extensive.

70. The size of an airline and its range of products are factors in the power of attraction FFPs have. In many respects, an airline with a relatively extensive range is better placed to offer an attractive FFP than a carrier with a less extensive range.<sup>37</sup> Firstly, an airline with an extensive range of products can offer travellers a wide selection of bonus trips, and FFPs that offer a greater number of alternatives are valued more highly by travellers. Secondly, a traveller is more likely to accumulate enough points for a bonus trip if the airline has a relatively large range of routes and departures. Thirdly, a traveller may consider that a large airline with a broad network is less likely to go bankrupt than a small newcomer (although cases such as Alitalia, Ansett Australia or US Airways show the contrary). The greater the likelihood of an airline going bankrupt, the less inclined a traveller is to use its FFP in a particular route. In other words, a large airline may have a relative advantage over a smaller one.

## **5.6. Empirical assessment for domestic air travel in Sweden**

71. The results of the analysis of domestic air travel in Sweden<sup>38</sup> show that the SAS EuroBonus scheme has resulted in a higher ticket price for SAS travel compared with the prices of other airlines and also compared with periods during which SAS did not apply EuroBonus on competitive routes. In comparative terms, the SAS price increase for business travellers represents about 12% (=SEK 375-440) of the other airlines' average ticket price. Compared with periods when SAS has no FFP in place, the increase in its ticket price represents about 8% (=SEK 225-290) of the average ticket price. In the case of airlines other than SAS, the EuroBonus scheme may have resulted in lower prices for business travellers.
72. Further, the results of the analysis show that the SAS EuroBonus scheme has had a significant effect on switching cost (see para 5.2) for SAS travellers. According to the estimated model, switching cost for SAS business travellers

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<sup>37</sup> One alternative for a small carrier wishing to offer a FFP of an adequate standard is to enter into an alliance with other airlines. A large airline, however, is in a better position than a small one to enter into an alliance with other large airlines.

<sup>38</sup> See the report "There is no such thing as a free lounge", Swedish Competition Authority Report 2003:1. Can be found at [http://www.kkv.se/eng/eng\\_index.shtml](http://www.kkv.se/eng/eng_index.shtml).

increased by almost SEK 500 (ca. € 55) per passenger during periods when the SAS EuroBonus scheme was in place, which represents almost 15 per cent of the average ticket price for airlines on competitive routes.<sup>39</sup> There is, however, nothing to suggest that switching cost for airlines other than SAS is affected by the presence of FFPs.

73. There are relatively few empirical studies showing the impact of FFPs on such factors as competitive conditions, switching costs, customers' willingness to pay and choice of airline.<sup>40</sup> Most of these studies are largely based on data from domestic air travel in the US. The results show that the lock-in effects correspond fairly closely to the estimated changes in ticket prices and switching costs that result from the presence of FFPs. This also indicates that the afore-mentioned results for competitive routes are plausible.
74. Consequently, there is much to suggest that the presence of the SAS's EuroBonus programme has had an impact on the market, partly in the form of higher list prices for SAS travel and lower list prices for travel with competing airlines, and partly in the form of higher switching cost for SAS travellers. As SAS is the dominant airline on most competitive routes, its FFP has resulted in higher list prices for a large share of the business travel segment. The increase in switching cost shows that the EuroBonus scheme has had an impact on the way business travellers appraise the benefits provided various airlines and thus on their choice of airline.

## VI. Summary

75. The air travel industry offers a wide range of loyalty programmes for travellers (FFPs), undertakings (CDS) and resellers (TACOs) (cp. chapter II). As the powerful position of the national flag carriers on the respective domestic market

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<sup>39</sup> The most flexible ticket was used for the study, i.e. the one with the least number of restrictions concerning its use. The aim was partly to make comparisons between airlines as straightforward as possible and partly to facilitate analysis of an airline's prices over time. As the highest ticket price was used, it appears more reasonable to relate size of switching cost to percentage of ticket price. If, for instance, actual prices were 20 per cent lower than those used in the estimated model, actual switching costs would be 20 per cent lower than estimated costs.

<sup>40</sup> See for instance Cairns/Galbraith (1990) l.c.; Morrison, S.; Winston, C. (1995): *The Evolution of the Airline Industry*. Washington: Brookings; Nako, S. (1992): *Frequent flyer programmes and business travellers: An empirical investigation*. In: *Logistics and Transportation Review* 28, pp. 395-414.; Prousalaglou, K.; Koppelman, F. (1999): *The choice of air carrier, flight, and fare class*. In: *Journal of Air Transport Management* 5, pp. 193-201; Storm, S. (1999): *Air transport policies and frequent flyer programmes in the European Community – a Scandinavian perspective*. Bornholm: Unit of Tourism Research at the Research Centre of Bornholm.

is threatened by new entrants and regulatory barriers to competition are removed, there is a concern that incumbent airlines are using loyalty programmes in order to maintain their “inherited” advantage.

76. Neither national nor European competition laws provide any specific rules on loyalty programmes. Under certain circumstances loyalty programmes can be qualified as an abuse of a dominant position under Art. 82. Although competition case law from around Europe is based mainly on Art. 82 the assessment of loyalty programmes in the light of Art. 81 is not excluded. Furthermore, each of the national competition laws as well as the EEA-Agreement provide provisions with respect to abusive behaviour by undertakings (cp. chapter III).
77. Almost all major airlines offer their travellers carefully designed FFPs. They are without doubt very efficient means of enhancing customers’ loyalty or fidelity. The main economic analysis in Chapter V shows that the impact of FFPs on competition is mainly derived from artificial economies of scope, switching costs, barriers to entry, and principal-agent relations. Therefore FFPs – especially those with a strongly non-linear (progressive) structure – may have welfare decreasing and anti-competitive effects. Empirical estimates for the domestic air travel in Sweden show, that the SAS EuroBonus scheme has resulted in higher switching costs for SAS business travellers, which increased by almost SEK 500 (ca. €55) or 15% of the average ticket price. The price of the ticket rose by 12% for business travellers compared to the prices of other airlines and by 8% compared to periods during which SAS did not apply EuroBonus on competitive routes (cp. chapter 5.6). The Swedish and the Norwegian competition authorities have intervened against FFPs while the European Commission tends not to prohibit FFPs but to open them up to other airlines (cp. chapter 4.1.3).
78. As to travel agent agreements varied interpretations were given. On the one hand, TACOs are equivalent to a discount granted to travel agencies not based on cost savings but on loyalty, which has been consistently condemned as an abuse of a dominant position in the past. Against this background there are various cases where national competition authorities (Finland, Norway, Italy, Spain) and the European Commission have started investigations or even prohibited certain reward schemes. On the other hand, in the last few years a growing number of airlines have begun to reduce their linear travel agent commissions significantly or to even abolish them. Instead the airlines have moved to a system of net prices. National competition authorities (Austria, Ireland, Germany, UK) have come to the conclusion that the reduction or abolishment of travel agent commissions does not infringe Art. 82 or the respective national provisions (cp. chapter 4.1.1).

79. Corporate discount schemes have ambiguous effects on competition. On the one hand, they reflect a certain transfer of market power from the seller to the buyer. As such, they can be viewed as sound examples of enhanced competition. However, many of these deals take forms that engender important lock-in effects, such as when the rebate is somehow progressive, i.e. the percentage discount given depends on the total volume of sales during a certain period of time on a certain air travel network. Such agreements provide an incentive for the buyer to concentrate his demand to one or a few carriers. Larger carriers will obtain an inherent advantage compared to smaller ones. In other words, such corporate discount schemes clearly have anti-competitive effects. Thus, several national competition authorities have conducted formal investigations on progressive volume rebates and some of them have already banned them (Norway, Germany) and the use of preference clauses (cp. chapter 4.1.2).