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AIRLINE COMPETITION

-- Note by Norway --

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1. Introduction

1. The Norwegian airline industry was deregulated in 1994. A strict regime was replaced by free entry for domestic airlines. Unfortunately, the deregulation did not lead to healthy competitive behaviour.

2. The first low-cost airline that tried to challenge the incumbents Braathens SAFE and Scandinavian Airlines (SAS) was Color Air. It was established in response to the opening of Gardermoen airport in 1998, which provided for sufficient landing slots to compete with the incumbents, in particular between Oslo and the second and third largest cities Bergen and Trondheim.

3. Following the establishment of Color Air, a 'war' broke out between it and the two incumbents. The result was increased capacity and empty seats, higher prices in the business segment, and clustering of time schedules. Color Air was a pioneer with its low-cost business model in Norway, with a denser seating and no frills. However, even if Color Air dropped prices significantly, it did not manage to attract the important business segment. An important reason for this was a lack of an attractive frequent flyer program that could compete with SAS' EuroBonus program.

4. After thirteen months and huge losses, Color Air gave up. In October 1999 the airline filed for bankruptcy.

5. SAS and Braathens SAFE continued competing neck-to-neck on domestic routes. By May 2001, Braathens SAFE was almost bankrupt and SAS made an offer to acquire the airline. The Competition Authority allowed the merger under the failing firm defence. The Norwegian airline industry returned to a monopoly situation.

6. The monopoly position of SAS did not last for long. In September 2002 the airline company Norwegian Air Shuttle (Norwegian) entered on four domestic routes. After that, we experienced price competition in the Norwegian airline industry for the first time after deregulation.

7. To understand the development from 2002 and onwards, the decision the Competition Authority made in April 2002 is important.¹ The authority banned earning points on the frequent flyer program of SAS, Braathens' and Widerøe on all domestic routes. The decision was formally based on section 3-10 of the previous Competition Act of 1993, which enabled the authority to intervene by decision or regulations against terms of business, agreements and actions that could limit competition contrary to the purpose of the law. A few months later, the Ministry² turned down a complaint from SAS and confirmed the decision made by the Competition Authority.

8. Consequently, from July 2002 SAS could no longer offer frequent flyer points on domestic flights. According to Norwegian, the ban on EuroBonus was decisive for their entry into the Norwegian market.

2. The ban on loyalty programs for domestic routes in Norway

9. The Competition Authority made the decision to intervene against the frequent flyer programs of SAS and its subsidiaries Braathens and Widerøe in 2002. The duration of decision was limited to 5 years.

¹ See decision V2002-28.

² The Ministry of Labour and Administration.

10. In 2007, The Competition Authority assisted the Ministry³ in the assessment to continue the prohibition. The Ministry's main arguments for the negative effects of the frequent flyer programs on competition were based on the loyalty effects locking-in customers and the barriers to entry for new competitors. The Authority's recommendation was that it was necessary and appropriate to introduce a regulation that would prohibit generally the earning of loyalty points. The continued ban was based on Section 14 of the Competition Act of 2004, which allowed the Authority to intervene against terms of business, agreements or actions that restrict or are liable to restrict competition.

11. The frequent flyer program regulation prohibited all airlines from granting frequent flyer points on Norwegian domestic air routes. The regulation was not time limited, and was valid until repealed.

12. In 2009, the EFTA Surveillance Authority (ESA) raised the question to the Norwegian government whether the prohibition could be considered a violation of the EEA Agreement by restricting the freedom to provide services. The background was that the prohibition could make it more difficult for foreign airlines to enter the Norwegian market because of the need to adjust their frequent flyer programmes. The Ministry's reply was that the prohibition had been important to establish competition on the domestic market, which again lead to more efficient routes from Norway to foreign countries. Therefore, the prohibition supported the intent of the EEA Agreement 36 on free movement of services. The Ministry also argued that the cost of foreign airlines to adjust their frequent flyer programs would be limited.

13. In 2011-2012 the Competition Authority undertook a thorough assessment of the economic effects of the ban on loyalty programs on domestic flights. The purpose was to investigate whether there still was a reason to prohibit loyalty programs. As part of the project, the Authority performed an extensive survey of the current market situation and a comprehensive review and assessment of the economic effects of the loyalty programs in the current market situation.

14. The Competition Authority also undertook a legal assessment of whether the terms of the Competition Act § 14 were fulfilled if the regulation was continued.

15. Based on the Authority's assessment of the economic effects of a reintroduction of loyalty programs, the Competition Authority believed that there was a risk that the competitive environment would worsen considerably, especially on the vulnerable lower-traffic routes. In several of the medium-traffic routes, it was a risk that the airline with the least attractive loyalty program would have to reduce capacity.⁴

16. The economic analysis also showed that the competitive constraints varied in strength. Variations in the strength of competitive constraints was an argument for a more differentiated, and split regulation. A continuation of the frequent flyer program regulation should, in the Competition Authority's assessment, be limited to that part of the market where competition is least robust, i.e., in the low-and medium traffic

³ The Ministry of Government Administration, Reform and Church Affairs

⁴ SAS' frequent flyer program, EuroBonus, is a frequent flyer program where members can accumulate points on flights, hotel stays, car rentals and certain purchases. These points can be redeemed at either SAS or partner airlines. EuroBonus has different membership levels, each with different benefits. Norwegian's loyalty program, called Norwegian Reward, is somewhat different from other frequent flyer programs. As a member you earn **cashpoints** on all your travels with Norwegian. As soon as cashpoints are earned, they can be redeemed at any time on a new flight, check-in luggage, seat reservations, cancellation insurance or ticket changes on Norwegian flights only. There are no membership levels, and one cashpoint equals one NOK. The Competition Authority assumed that given the two airlines current loyalty programs, Norwegian had the least attractive loyalty program.

routes. The Competition Authority was therefore of the opinion that the three largest domestic routes had sufficient demand to allow further airline entry, even with loyalty programs.

17. Initially, the Norwegian government declined the Authority's suggestion of a split regulation. In October 2012, the Government decided to keep the general ban on earning bonus points for all domestic flights. Following this decision, ESA decided to open a case against Norway. In May 2013 the Government made a new assessment of the case and came to a different conclusion. Thus, the government decided to lift the ban. The Government shared the Competition Authority's concern about the possible effects in rural areas with a reintroduction of bonus programs, yet it was the Government's view that the competition in the market now was more robust than when the regulation was introduced in 2007. The Government concluded that a continued general ban on earning bonus points for all domestic flights was disproportionate.

18. The Government found that the Competition Act's ban against abuse of a dominant position together with the Authority's powers to investigate and collect information from stakeholders combined were sufficient tools for the authority to ensure that the airline companies would not utilize the bonus programs for anti-competitive behavior. At the same time, the Government was very clear that it did not share ESA's legal assessment that the bonus ban was in breach of the EEA Agreement.

19. The Government gave the Competition Authority the task to monitor the domestic airline market closely to make sure that the market players would continue the strong competition that existed before the ban was lifted.

20. Prior to the government's removal of the ban on frequent flyer programs, SAS challenged the Norwegian government by reintroducing their frequent flyer program EuroBonus in March 2013. The airline argued that it could not be banned because it was only made available to business travellers, and was therefore a business-to-business agreement. Consequently, the Competition Authority decided to open a case on SAS's new bonus program. The Authority considered that it could constitute an illegal re-introduction of EuroBonus.- However, the case was later dropped since the government decided to allow frequent flyer programs in Norway two months later.

21. As part of the efforts to monitor the airline market, the Competition Authority has asked the two domestic airlines, SAS and Norwegian, to submit financial and traffic data on a quarterly basis.

3. The Norwegian domestic airline market

22. Despite its relatively small population of approximately 5 million people, the Norwegian airline sector has many of the similar features observed in other European countries. The largest routes in Norway are almost equal in size as many routes between major airports within the EU.⁵ The country's topography and a relatively widespread population are some of the main reasons for this. There has also been a political will to maintain a network of smaller and larger airports and domestic routes. The airport coverage in Norway is good, and two out of three citizens have access to an airport within one hour⁶.

23. In addition to the two airlines, SAS and Norwegian, operating on the domestic market, the Norwegian airline sector has also had smaller carriers operating the regional routes, many provided

⁵ Norwegians fly nine times more than the average European, and three of the domestic routes in Norway are among the 21 busiest routes in Europe (see Marit Kristine Veia and Mekonnen Germiso (2012), Working paper I/2012 *Framtiden i våre hender*).

⁶ See Svein Bråthen, Nigel Halpern and George Williams, Report 1205, Møreforskning 2012.

through public purchase of services. In this segment of the market, there is one dominant market player: Widerøe.

24. After Norwegian was established, it gradually expanded and into a nationwide network. Its market share on domestic routes grew from 12 percent in 2003 to 36 percent in 2011. Today, SAS and Norwegian have approximately the same market share on international routes out of Norway, around 30 percent. Internationally, Norwegian has grown rapidly and is now one of Europe's leading low-cost airlines.

25. It is difficult to find good estimates for the price development on domestic flights for Norway as a whole, but calculations done by the Competition Authority on a route-by-route basis, showed that average prices has fallen the last decade. The price reduction has mainly been for economy price tickets and on routes with more than one operator. The Authority's investigations also showed that the number of business travellers buying economy class tickets had increased during the period from 2005 until 2010.

4. The effect of the ban on loyalty programs – results of the Competition Authority's economic analysis

26. In 2011-2012, The Competition Authority undertook a thorough assessment of the economic impacts of the bonus prohibition in the market. The purpose was to investigate whether there was a basis for a continued ban on earning bonus points in Norwegian domestic air travel.

27. The Competition Authority obtained extensive information from market participants. In addition, price and traffic data were collected from other sources. Based on these data, the Competition Authority performed an analysis of the market situation for the Norwegian airline sector. Furthermore, the Authority conducted several quantitative analyses to assess the effects of bonus programs more generally.

28. The review showed that the competitive environment had changed significantly after the ban on frequent flyer programs was imposed. The increased competition had contributed to a decline in average prices in the Norwegian domestic air transport. Where the carrier Norwegian had entered the former monopoly routes, the average price had fallen.

29. The Authority's view was that the loyalty-building effect of the bonus program was still significant, although there were indications that it had somewhat diminished in recent years. One of the reasons being that the value of a free travel had been reduced.

30. SAS argued that the principal-agent problem was no longer relevant due to more employers being conscious in keeping travel costs down. In order to consider SAS' claim, the Authority contacted a range of Norwegian companies to map out their purchasing procedures for flights. The survey showed that the employees largely purchased tickets individually with the opportunity to retain earned bonus points for private use. At the same time, the employees freedom of action had been somewhat reduced in recent years through guidelines provided by the employer.

31. The Competition Authority found that the value of a bonus travel increased with the airline's route network. Although Norwegian has grown rapidly in recent years, the business model of SAS as a network company as well as its membership in Star Alliance, makes Eurobonus, the bonus program of SAS, to have a greater attractive effect than Norwegians' bonus program.

32. In addition to the survey, the Competition Authority carried out its own research to try to quantify the effects of the airline bonus programs. The data included domestic routes in Norway and Sweden, as well as a range of international routes out of the three capitals of Scandinavia.

33. To test the effects of EuroBonus, the Authority primarily wanted to test the price and quantity (number of passengers) effects of the introduction of the ban on bonus points in Norway directly. However, this was not possible for several reasons, one being that the implementation of the ban coincided with the establishment of Norwegian. The Competition Authority therefore had to look for indirect ways to test the effects of the EuroBonus scheme.

34. Essentially, the Authority chose two different analytical strategies to measure the (indirect) effects of EuroBonus: (i) the natural experiment observed in Sweden where the bonus program was removed and then implemented again, and (ii) bonus shares (the proportion of travellers with EuroBonus) for the relevant routes/customer groups as an instrument to explain the effect of the bonus program.

35. The Competition Authority had expected that the results of the empirical studies would make it possible to quantify some of the effects of bonus programs on competition in the Norwegian airline sector. This was particularly true in relation to the natural experiment observed in Sweden where bonus programs as mentioned were removed and then introduced again. In Sweden, from October 2001 to February 2009 it was not possible to use points (buy flights) on routes with competition. Earning bonus points was allowed on all routes. The analysis showed that earning bonus points and especially earnings to various membership levels, was likely to be the most important incentive in the EuroBonus program, and that the Swedish regulation was not as effective as intended, and in any case not directly comparable with the Norwegian ban.

36. With regard to the analysis of the use of bonus shares, it turned out to be difficult to find robust econometric models. Thus, the analysis made it difficult to draw clear conclusions. To the extent that one could say anything about the effects of the EuroBonus program, it went in the direction that it increases the number of passengers in the business segment, but that the effect is small compared to the total number of passengers.

37. The Competition Authority also conducted an analysis of whether a possible re-introduction of bonus programs on Norwegian domestic routes would result in a transfer of business travellers from Norwegian to SAS. Since business travellers make up the majority of full paying passengers, a consequence of a reintroduction of bonus programs could be that Norwegian was forced to reduce its capacity on small routes, ie. routes with few passengers, few departures and typically low earnings.

38. In order to estimate the possible extent and characteristics of capacity transfer from Norwegian to SAS, the Competition Authority carried out an analysis built around a formal numerical model of the market for aviation based on the company's cost structure and demand patterns. In the model, multiple market equilibria were compared under different assumptions related to how much a new regime with bonus programs would mean for the airline passenger's loyalty.

39. The result of the numeric analysis showed that Norwegian would lose profit in the business segment. It also showed an increase in the number of passengers in economy class, but that this increase was not enough to offset the loss of income in the business segment. However, the Authority concluded that it was difficult to predict what would happen in the market, given the uncertainty about the extent to which the introduction of bonus programs would shift the market share between SAS and Norwegian. On the other hand, the simulations done on small routes indicated that even a slight change would cause the profitability of Norwegian to worsen significantly.

40. In sum, the Competition Authority found that the loyalty-building effect of the bonus program was still significant. The loyalty programs continued to give an incentive to collect all purchases from one airline. This effect was reinforced by elements such as the principal-agent problem and network effects.

41. The Authority was of the opinion that the conditions of competition – to which the loyalty point ban was central – worked well. The Authority was therefore concerned that competition could be weakened if loyalty programs were reintroduced.

42. Furthermore, the Competition Authority found it reasonable to assume that a reintroduction of loyalty programs in the Norwegian domestic airline sector would lead to business travellers choosing the airline with the most attractive loyalty program. As business travellers constitute the majority of those paying full price tickets, this could have significant consequences for an airline with the least attractive loyalty program. This may again cause airlines to reduce capacity on low-traffic routes.

5. The effects of loyalty programs – further analysis

43. The ban on earning frequent flyer points on domestic routes was introduced in 2002. It was important for the airline company Norwegian's decision to challenge the incumbent SAS. The story illustrates that frequent flyer schemes can have severe lock-in effects and constitute a significant barrier to entry. Norwegian is now one of Europe's leading low-cost airlines.

44. The ban was lifted by the government in 2013. It was considered that competition on domestic routes was significantly robust to justify this. However, the Ministry has given the Competition Authority the task of following closely the developments in the Norwegian airline sector. The Authority will therefore be collecting information from the airlines and other relevant data, and continue to monitor the domestic airline market.