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DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
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AIRLINE COMPETITION

-- Note by Israel --

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This note is submitted by Israel to the Competition Committee FOR DISCUSSION under Item IX of the agenda at its forthcoming meeting to be held on 18-19 June 2014.

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Introduction

> "Competitive harm to the 'aerial gateway' to Israel, is, in effect, a deep injury to the different branches of the economy. The importance of this sector and its effect on the economy as a whole mandate professional scrutiny of competitive effects, for the benefit of consumers and the general public."[1]

1. Since the enactment of the Restrictive Trade Practices Law 5748-1988,[2] there have been dramatic changes in the regulatory framework governing the aviation industry in Israel. These changes reflect the position that more competition in this sector would benefit consumers and the Israeli economy as a whole. New legislation, regulations and international agreements, in particular, "open skies" agreements with the USA (2010) and the EU (2013), have resulted in the lowering of entry and expansion barriers and a potential increase in the number of airlines operating international flights to and from Israel.

2. The applicable competition law regime has also changed dramatically. Amendments to the Law have narrowed the scope of the provision exempting restrictive arrangements in the aviation industry from the Law. This move was accompanied by the issuing of a set of block exemptions, which were tailored to facilitate airlines' entry into efficient operational arrangements on the one hand, without restricting competition on the other. As it became apparent that the "open skies" agreements were to remove obstacles to competition, the Director General reacted by issuing additional block exemptions, allowing airlines to enter certain operational arrangements, based on their self-assessment of such arrangements' competitive effects.

3. Israel's submission will focus on these developments.

1. 1988-2007 – Broad Exemption

4. Under the Law, it is illegal to be party of a restrictive arrangement that has not been authorized by the Antitrust Tribunal, or exempted from such authorization by the Director General. However, the Law provides that arrangements which meet certain requirements are not to be deemed restrictive arrangements under the Law. It follows that such arrangements do not require prior authorization, regardless of their effect on competition.[3]

5. This was the case with a wide range of arrangements in the aviation industry. Upon its enactment, section 3(7) of the Law provided that "[a]n arrangement, involving restraints, all of which relate to international air or sea transport, or combined air and ground international transport" is not to be deemed a restrictive arrangement, provided it meets two requirements. The first requirement concerns the identity of the parties to the arrangement: an arrangement would be exempt if all the parties to it were either "(1) sea or air carriers; or, (2) sea or air carriers and an international association of air or sea carriers approved for

[1] Israel's Antitrust Authority Report for the Year 2006, p. 30 (in Hebrew).

[2] For an updated English translation of the Law see: http://www.antitrust.gov.il/eng/Antitrustlaw.aspx

[3] Such an exemption does not, however, derogate from the provisions of the law concerning mergers, monopolies etc.

this purpose by the Minister of Transport." The second requirement was that the Minister of Transportation be notified of the arrangement.[4]

6. Similar exemptions existed in other competition law regimes.[5] Under the umbrella of this rather broad exemption, airlines were relatively free to collaborate and cooperate among themselves, without having to seek prior approval. While this facilitated certain types of efficient and procompetitive operational arrangements, it also exempted arrangements that restricted competition, to the detriment of consumers.

7. The IAA sought to limit the scope of the exemption and advocated in favor of amending the Law. The IAA's position was echoed in the Government's explanatory note accompanying a proposed amendment of the Law in 2000 (which was not made into law): "[t]his exemption restricts competition in the aviation sector, harms the level of service and raises prices of flights." In the explanatory note accompanying the 2006 bill (which led to the amendment of the law in 2007), the Government explained that section 3(7):

8. "[E]nables the creation of restrictive arrangements which harm competition and users [of airline services], which, *inter alia*, involve price fixing and market allocation schemes between carriers. The result is that despite the fact that such arrangements have the potential of inflicting serious harm to competition, they are immune from scrutiny and regulation. The establishment of such arrangements may thwart efforts to increase competition in the aviation sector, whose purpose is to increase capacity and availability and reduce the prices of flights, to the benefit of consumers".

2. 2007-2012 – A New Balance

9. The Law was finally amended in 2007, thus limiting the scope of the exemption. This amendment took effect in January 2009, following the Director General's issuing of the detailed Restrictive Trade Practices Rules (Block Exemption for Arrangements between Air Carriers), 5769-2008 ("the 2008 block exemption"). The new regime established by the amendment to the Law and the block exemption still facilitated airlines' entering into efficient, pro-consumer and pro-competitive arrangements, but no longer provided a *carte blanche* to anticompetitive arrangements that focus on the Israeli market. Subsequently, a number of restrictive arrangements between El Al Israel Airlines ("El Al") and other airlines were brought under the review of the Director General. In a number of substantive decisions issued, the Director General laid out the methodology for reviewing codeshare and joint marketing arrangements between airlines, and thus provided guidance to airlines considering entering such arrangements.

10. We discuss these developments in the following paragraphs.

2.1 The 2007 Amendment

11. As noted, the Government proposed limiting the scope of the exemption already in 2000.[6] This was only implemented in 2007, with the addition of section 3A of the Law, which provides that,

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[4] Arrangements in the aviation industry were exempt before 1988 as well: a 1961 amendment to the previous law of 1959 provided that "an arrangement in which all the restrictions concern the terms applicable to the transportation of passengers or freight at air or sea - is not a restrictive arrangement".

[5] See OECD, Israel – Accession Report on Competition Law and Policy, 2011, p. 84.

[6] The proposition was to apply the exemption only where Israel is a party to an international agreement requiring the implementation of a restrictive arrangement, and provided the benefit to the public exceeds the harm caused by the arrangement.

notwithstanding the provisions of section 3(7) of Law discussed above, arrangements that meet either of the following conditions will no longer be exempted from the Law:

> “1.The parties to the arrangement are Israeli air carriers;
>
> 2. The parties to the arrangement are air carriers at least one of whom is Israeli and at least one of whom is not Israeli;
>
> 3. The following two conditions are met:
>
> a) The parties to the arrangement are non-Israeli air carriers at least one of whom maintains an operation or has a representation in Israel;
>
> b) One of the principal issues of the arrangement is air transport to or from Israel, and the restraints contained in the agreement relate to the operation in Israel or lack thereof of any of the parties.”[7]

12. The amendment’s entry into force had been delayed until two months after the Director General issued the 2008 rules, which exempted parties to certain arrangements from the duty to seek prior approval.

2.2 The 2008 Rules

13. Acting under the authority granted by section 15 of the Law, the Director General issued detailed block exemptions applicable to the aviation industry. These rules cover and exempt various types of technical arrangements, such as agreements for the provision of maintenance (including spare parts), fueling, cleaning, security and other types of services; supplying disposable items such as meals, beverages and toiletries; assisting and providing services in cases of emergency; etc., and joint frequent flyer programs.

14. Arrangements for the leasing, chartering or exchanging of aircraft, interline ticketing and joint marketing of passenger or freight capacity (including codeshare agreements), could also be exempted, provided the criteria set out in the 2008 rules were met. To illustrate, the rules do not cover joint marketing arrangements between more than one Israeli airline, or those for the marketing of capacity on direct flights between Israel and a foreign destination, where this destination serves as a "hub" or "home airport" for two or more of the parties to the arrangement etc.[8]

15. In 2013, the Director General issued the Restrictive Trade Practices Rules (Block Exemption for Arrangements between Air Carriers) (No. 2), 5773-2013. These rules are mostly identical to the 2008 rules. The provisions exempting certain arrangements for the lease, charter or exchange of aircraft, however, were modified.

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7 The amended Law does, however, empower the Minister of Transport to authorize an arrangement where such a decision is necessary to prevent “substantial harm to Israel's foreign relations, including its foreign economic and trade relations, or in order to guarantee the continuity of air freedom rights between Israel and other countries”. Such a decision may not be issued before having received the Director General’s opinion on the matter.

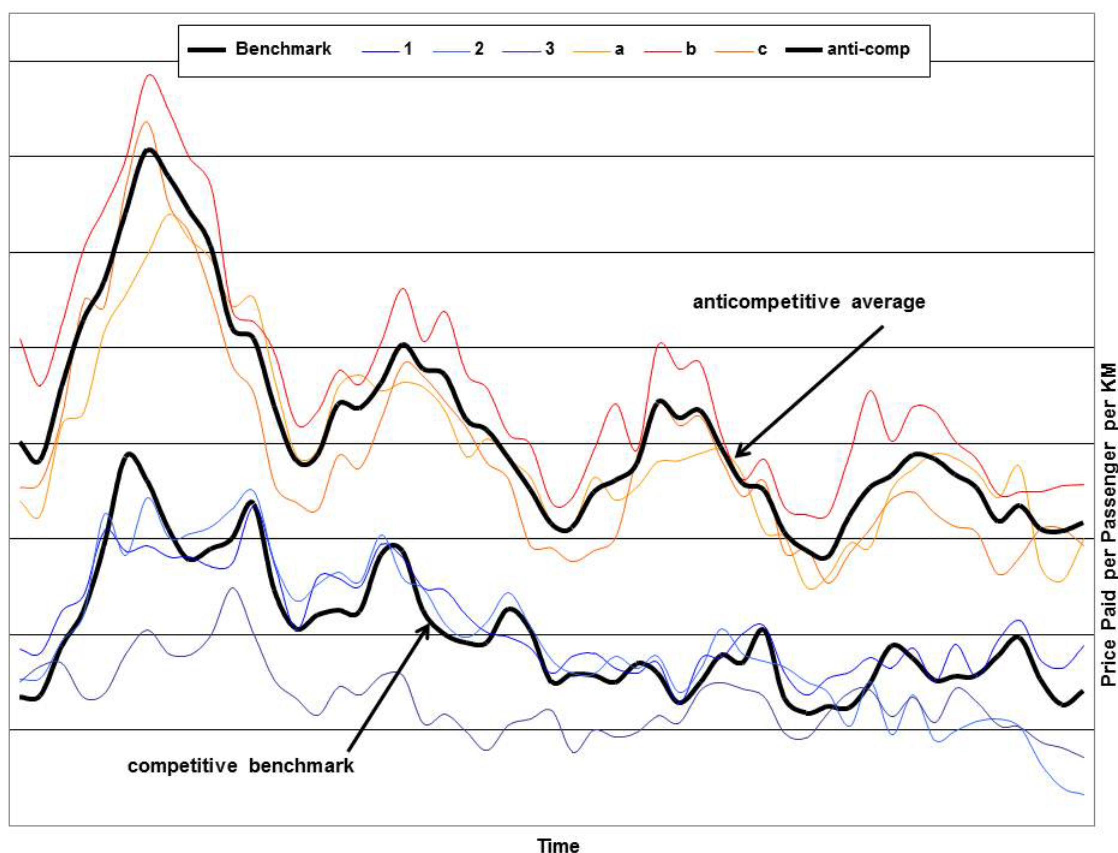
8 A “home airport” is defined as accounting for more than 20% of a carrier’s international take-offs and landings and any airport within a distance of 120km from said airport. If no airport meets this criteria, then the three airports accounting for most of the carrier’s take-offs and landings are deemed the carrier’s “home airport”.

2.3 Review of Arrangements between El Al and foreign Airlines

16. Following the application of the new competition law regime, El Al submitted more than twenty exemption applications regarding its arrangements with other airlines. While some of these arrangements were exempted for 3 years, six were not, and El Al withdrew some of the applications.

17. The review of El Al's arrangements involved an in-depth analysis of extensive data collected on flight prices, frequencies and timetables, the volume of passengers travelling on the different routes, commissions and other payments transferred between airlines, etc. Information on entry and expansion barriers, and the legal framework established by Israel's bilateral air transport agreements with the relevant destination countries were also incorporated into the analysis.

18. The IAA found it useful to compare prices paid by passenger per kilometer ("adjusted price") across different routes. Each line in the figure below depicts adjusted prices of flights on a particular route, over time. The "anti-competitive average" line represents the average adjusted price for flights on routes where competition levels were relatively low, while the "competitive benchmark" represents the average adjusted price for flights on routes where a relatively higher degree of competition prevailed.



19. It comes as no surprise that, in general, competition and consumers were most harmed on routes where El Al contracted its sole competitor, and where significant barriers to entry and expansion restricted competition. This was the case with El Al's joint marketing and codeshare agreements with Austrian Airlines, LOT, Bulgaria Air and Tandem-Aero. At the time, Israel's bilateral air transport agreements with Austria, Poland, Bulgaria and Moldova only allowed for two carriers to operate on direct routes from Israel to each one of these countries (one carrier from each country). The Director General found such arrangements, between the only two rivals in the respective markets for direct flights between Tel-Aviv

and either Vienna, Warsaw, Krakow, Sofia or Kishinev – markets to which entry by other airlines was infeasible, to be anticompetitive. As a result, El Al and the other airlines terminated these arrangements.

20. A similar analysis initially led the Director General to refuse to grant an exemption to El Al's agreement with Aerosvit in 2009. By 2011, however, understandings between Israel and the Ukraine liberalized the regulatory framework governing flights between the two countries: flight frequency and overall capacity could be increased; new carriers were allowed to operate flights, including some charter flights; flights could now be operated between Israel and additional destinations (other than Kiev) within the Ukraine, etc. In the decision to exempt the arrangement between Aerosvit and El Al in 2011, the Director General noted that new carriers had in fact entered the market, and that with the capacity and frequency restriction alleviated, entry barriers were substantially reduced. .

21. The agreement between El Al and Air India raised special concerns. The bilateral air transport agreement between Israel and India not only limited the number of carriers operating direct flights between the countries to two, but also provided that either of the two carriers may cease its operation of flights on the route, in exchange for royalties. In 1998, Air India and El Al implemented this clause in the bilateral agreement, with Air India discontinuing its flights in exchange for royalties paid by El Al.[9] El Al thus remained the only carrier operating flights between Mumbai and Tel-Aviv – a complete monopoly in that market.[10] In the view of the Director General, this was a "naked restraint", with the sole purpose of reducing or eliminating competition. While this finding was enough to justify the refusal to exempt this arrangement, the Director General nevertheless examined the arrangement's effects on consumers, and found that prices and profitability levels on the Mumbai-Tel-Aviv route were considerably higher than those prevailing in comparable routes that are more subject to competition.

22. As mentioned above, the remainder of El Al's exemption applications were either granted on the grounds they did not raise competitive concerns, or withdrawn by El Al.

3. 2012-2014 – "Open Skies"

23. Following more than three years of negotiations, the EU and Israel signed an "open skies" agreement in June 2013, rendering Israel's bilateral air transport agreements with the 27 EU member states obsolete. The agreement sought to remove regulatory restrictions on air traffic between Israel and the EU, and to promote competition by lowering entry and expansion barriers.[11] Israel signed a similar agreement with the USA in December 2010.

24. Anticipating the pro-competitive environment that was to be created once the "open skies" agreement with the EU is concluded, the Director General issued the Restrictive Trade Practices Rules

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9 The General Director noted the agreement between El Al and Air India included other restrictive provisions, e.g. agreement to cooperate in the setting of timetables, prices and price structures, to increase capacity only in agreement (with each airline reserving the right to enjoy half of the increased capacity), to consult and exchange information etc. Naturally, despite the concerns such restraints raise in regular circumstances, the General Director's decision was focused on the absence of competition between El Al and Air India.

10 Note that El Al had already been declared a monopoly in the transportation of time sensitive and price sensitive passengers to Mumbai (and other destinations) in 2005, on account of its retaining over 50% of the market share on that route (see section 26 of the Law).

11 According to the Civil Aviation Authority, at the time the "open skies" agreement was concluded, air traffic between Israel and the EU accounted for around 60% of the passengers travelling to and from Israel. See: http://caa.gov.il/index.php?option=com_content&view=article&id=942:-q-q-&catid=157:2010-05-03-09-38-31&Itemid=251 (in Hebrew).

(Block Exemption for Arrangements Concerning Marketing Flight Capacity to Destinations Covered by Open Skies Agreements), 5773-2012 ("the 'open skies' rules"). These rules cover codeshare agreements, as well as flight capacity marketing arrangements, which allow carriers to sell capacity on another carrier's flight, applicable to routes between Israel and destinations in the EU and USA, with whom Israel has "open skies" agreements ("'open skies' arrangements").

25. Rather than providing a detailed list of requirements an arrangement must meet in order to be exempt, the "open skies" rules sets standards:[12] airlines may enter an "open skies" arrangement provided (1) "[t]he arrangement does not limit competition in a considerable share of a market affected by the arrangement, or is liable to limit competition in a considerable share of such market but does not substantially harm competition in that market"; and (2) "[t]he objective of the arrangement is not to reduce or eliminate competition, and the arrangement does not include any restraints which are not necessary to fulfill its objective" ("exemption standards").

26. The language setting the exemption standards for "open skies" arrangements is almost identical to that of section 14 of the Law, which empowers the Director General to exempt restrictive arrangements that meet the aforementioned standards. However, in the case of "open skies" arrangements, the burden to assess whether a particular arrangement meets the exemption standards lies directly on the parties to the arrangement. The approach taken in this particular context reflects the gradual shift towards self-assessment of restrictive arrangements, designed to alleviate the bureaucratic burden on parties and free up IAA resources.[13] The Director General is able to challenge such an arrangement ex post and impose sanctions, such as administrative fines, in cases in which the arrangement may substantially harm competition in the market.

4. Conclusion

27. The liberalization of the regulatory framework governing air transport to and from Israel has led to the creation of a pro-competitive environment, in particular in routes now covered by Israel's "open skies" agreements with the USA and EU.

28. The applicable competition law regime has changed in response: while airlines are no longer free to engage in anticompetitive agreements, they are free to cooperate, provided the arrangements they enter meet the rules and standards set out in the Law and the relevant block exemptions. At the same time, the Director General remains vigilant, and retains the power to intervene, should a particular arrangement fail to meet the applicable rules or standards.

[12] Note that in order to enjoy the block exemption, the parties to an arrangement must also notify the Director General of the arrangement before it takes effect.

[13] See also: Restrictive Trade Practices Rules (Block Exemption for Non-Horizontal Arrangements without Particular Price Restrictions), 5773-2013 (in Hebrew).