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**DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
COMPETITION COMMITTEE**

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AIRLINE COMPETITION

-- Note by South Africa --

18-19 June 2014

This note is submitted by South Africa 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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1. Introduction and background

1. The OECD has invited written contributions from members and observer members of the OECD for the Roundtable discussion on “Airline Competition” to be held on 19 June 2014.

2. Established in 1935, South African Airways (“SAA”) is South Africa’s leading airline operator. Up until 1991, SAA, as the flag carrier, was protected from competition. Over this period SAA was the only service provider on all main domestic routes. Airlines that hoped to compete with SAA were required to prove, amongst others things, that a need for their services existed and that the incumbent airline was not delivering an adequate service. The requirements were a significant barrier to entry. As a result SAA had a monopoly on the high density routes with the private sector airlines being relegated to feeder routes.¹

3. Post deregulation, the next ten years were characterised by entry and exit of several airlines. SAA continued to provide air transport services in the domestic market, but faced some competition. A three tiered alliance was established late in 1993 between SAA, South African Express (“SA Express”) (operating lower-density domestic routes (Bloemfontein, Kimberley, East London) and South African Airlink (“SA Airlink”) (operating feeder routes to the main hubs in South Africa as well as regional air transport services) which enabled the airlines to provide an expanded service offering.

4. Comair is a privately owned South African company listed on the Johannesburg Stock Exchange (“JSE”). Comair was established in 1946, but entered the mainstream routes in 1992.² Comair increased its market presence when it partnered with BA Plc in 1996, to operate under the BA brand and also when it launched Kulula in 2001

5. In the first ten years following deregulation, airlines that entered the market included Flitestar³, Nationwide⁴, Phoenix Airways⁵ and Sun Air⁶; however, none of these airlines were able to gain significant market share in the domestic market with all subsequently exiting.

6. Since 2001, the domestic air transport market has been characterised by the entry and exit of the low-cost carriers. Kulula was the first low-cost carrier to enter the South African market. 1Time entered the market in 2004 and exited in 2012. Mango Airlines (“Mango”) entered the market in 2007. SAA owns Mango. Velvet Sky entered the market in 2011 and exited in 2012.

7. Regulation has a recently come up as a significant barrier to entry. In particular, the Airline Services Licencing Act of 1990, this Act stipulates a maximum threshold of 25% foreign ownership in any license holding company, with the Transport Minister being eligible to waive this threshold should he/she find such cause. Importantly though, there has never been a successful application for this exemption.⁷ In

¹ The three private airlines on these feeder routes prior to 1990 included: Comair (operational since 1944), Link Airways (later known as SA Airlink) (operational from 1978) and Bop Air (later known as Sun Air) (operational from 1979).

² <http://www.comair.co.za/about-us/the-comair-story>

³ From 1991 to 1994. Flitestar focused on the Johannesburg–Cape Town and the Johannesburg–Durban–Port Elizabeth routes.

⁴ From 1995 to 2008. Phoenix airways focused on the Johannesburg, Durban and Cape Town routes.

⁵ From 1994 to 1995. Sun Air operated on the main domestic routes in South Africa.

⁶ Entered in 1994 and purchased by SAA in 1999.

⁷ In early 2013, Fastjet attempted to purchase 1Time to get hold of 1Time’s licences. Competitors such as Comair, SAA and Mango objected and the acquisition failed. Similarly, in late 2013 Comair appealed

addition, the Airports Company of South Africa (“ACSA”) is a state owned monopoly that owns and operates nine airports across the country. ACSA’s charges include landing charges, passenger service charges and aircraft parking charges. Its charges are regulated by the Regulating Committee, established through the Airports Company Act of 1993. The Regulating Committee does not regulate market access or grant licenses.

8. In this submission, we briefly discuss the main competition issues the South African airline industry.

2. Competition issues in the airline sector

2.1 Abuse of dominance

2.1.1 SAA I⁸

9. In July 2005, the Tribunal found that SAA contravened section 8(d)(i) of the Competition Act because it had engaged in two prohibited practices in the period from 1999 to 2001 (“SAA I⁹”). These practices were referred to as the ‘override incentive scheme’ and the ‘explorer scheme’.

10. The override incentive scheme involved incentive contracts between SAA and a large proportion of South African travel agents. The contracts were designed such that the agents received a flat basic commission for all SAA sales up to a target in Rand, specified in the contract. When the target was reached, the agents were eligible for two further types of commission in addition to the basic payment:

- The ‘override commission’ was paid if the agent exceeded the target. This commission was paid not only on the amount above the target, but on the whole amount below and above the target, referred to as the ‘back to rand 1’ principle.
- The second type of commission was paid only on the amount in excess of the target (the incremental sales), referred to as the ‘back to rand base’ principle.

11. The second practice of the incentive agreements, the explorer scheme, was aimed at rewarding individual travel agency staff with free travel on SAA flights in return for reaching sales targets for SAA tickets. It operated in a similar way to a frequent-flyer scheme. Therefore, rather than targeting travel agencies as a whole, the scheme provided the individual travel agents with a strong personal incentive to sell SAA tickets. The explorer scheme came to an end in June 2002.

12. The Tribunal found SAA being dominant had abused its dominant position by implementing the travel agent commission payment scheme during the period between October 1999 and May 2001. This was primarily due to the fact that this scheme had a retroactive ‘back to rand 1’ structure.

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

Safair’s entry into the local market on the grounds that the airline does not have a 75% ownership by local individuals and in October 2013 the North Gauteng High Court granted an interdict preventing entry of Safair’s new low-cost airline, FlySafair. However, in March 2014 the airline was granted its operating license.

⁸ Competition Tribunal of South Africa, *Competition Commission v South African Airways (Pty) Ltd* (Case No. 18/CR/Mar01)

⁹ Competition Tribunal of South Africa, *Competition Commission v South African Airways (Pty) Ltd* (Case No. 18/CR/Mar01)

2.1.2 *SAA II¹⁰*

14. SAA I related to agreements that SAA had in place from 1999 to 2001. However, various similar agreements remained in place beyond 2001.

15. Comair lodged a complaint with the Commission about these post-2001 agreements in October 2003. The complaint was referred by the Commission to the Tribunal for adjudication in October 2004.

16. Shortly after the SAA I, SAA's agreements were changed. The elimination of the retroactive design of the incentive contracts, applicable from April 2005, then formed part of a settlement agreement with Commission. The Tribunal confirmed the settlement agreement in December 2006. SAA agreed to pay an administrative fine of R15 million. The settlement agreement did not contain an admission of liability on the part of SAA for the period between May 2001 and March 2005. As a result, Comair and Nationwide chose to continue to fight the case at the Tribunal. A finding of contravention is a prerequisite for the institution of an action in the High Court for damages.

17. In February 2010, the Tribunal found that SAA had abused its dominant position during the period between May 2001 and March 2005. Essentially, SAA II related to similar conducted covered in SAA I. the only difference being that the SAA II decision extended the analysis of effects that is contained in SAA I. Federico (2013) explains that the SAA loyalty discount cases represents a clear example of why rivals in the market were not able to profitably match the incentive schemes of SAA which led to their foreclosure in the domestic market.

18. Lastly, it should also be noted that the Commission is currently investigating a complaint brought against SAA by Comair in November 2012. Comair is alleging that SAA has contravened the Competition Act by providing incentives to travel agents to sell passengers tickets on SAA flights rather than those of competitor airlines, such as BA/Comair. The Commission is currently investigating the allegations.

2.1.3 *Market definition*

19. In SAA I, the relevant market was defined as the overall domestic airline market in South Africa, without distinguishing it by type of passenger and/or fare, or by route. This was regarded appropriate at the time given that by May 2001 no low-cost carrier had entered the South African domestic market (see Federico (2013)). Moreover, a route-by-route definition of the market was not relevant at the time given that SAA's conduct as alleged in that investigation affected all domestic routes at the same time by virtue of the fact that the incentive schemes were based on total domestic sales made by travel agents.

20. The issue of market definition was however greatly contested and debated during the second abuse of dominance heard by the Tribunal in 2008 and 2009 (*SAA II¹¹*). This was not so much for its implications on the evaluation of SAA's dominance, but rather for its impact on the analysis of effects. Indeed, as correctly stated by Federico (2013), the *SAA II* case provides a good example of a case where market definition was not considered as an end in itself, but was primarily used as an analytical tool to properly isolate and identify the possible anti-competitive effects of the conduct of a firm with significant market power.

¹⁰ Competition Tribunal of South Africa, *Nationwide Airlines (Pty) Ltd & Comair Ltd v South African Airways (Pty) Ltd* (Case No. 80/CR/Sep06).

¹¹ Competition Tribunal of South Africa, *Nationwide Airlines (Pty) Ltd & Comair Ltd v South African Airways (Pty) Ltd* (Case No. 80/CR/Sep06).

21. The main market definition issues at stake in *SAA II* revolved around the significant changes that had taken place in the South African domestic airline market since 2001. Kulula was launched as a low-cost carrier by Comair in August 2001 and this was also subsequently followed by the entry of another low-cost carrier entrant in the form of 1Time in 2004. The growth of low-cost carriers between 2001 and 2005 which is the relevant time period for the complaint in the *SAA II* case raised the issue of whether the market definition adopted by the Tribunal in *SAA I* should be modified. As explained in the context of *SAA II*, this market definition question had significant implications for the effects that could be potentially attributed to SAA's conduct.

22. If the market had been defined in *SAA II* as a unique and largely undifferentiated market, this would have implied that bypass opportunities would have been available both to SAA's competitors and to its consumers. This would be as a result of the ability of SAA's rivals to mitigate and circumvent much of the foreclosing effect of SAA's conduct by selling tickets through the internet. Similarly, passengers would have been able to escape most of the associated consumer harm by buying their tickets online. However, the evidence before the Tribunal pointed to the presence of a significantly differentiated market, and arguably to the existence of separate markets for time-sensitive and non-time-sensitive passengers.

23. Ultimately, the Tribunal did not depart from the definition of the market definition adopted in *SAA I* and found in favour of a unique market for domestic air travel in South Africa. However, it crucially recognised the extensive degree of product differentiation present in this market and identified a "Travel Agent Segment", which included all tickets sold through travel agents and which comprised the higher fare tickets. As the Tribunal stated in its decision in the matter, the effect of SAA's behaviour on competitors and consumers, if present, would need to be located primarily in the Travel Agent Segment which roughly comprised 70% of all sales during the relevant time period.

24. It is therefore apparent from the Tribunal's decision in *SAA II* that the market definition proposed is required to not only undergo the hypothetical monopolist test, but also a test under which the relevant theory of harm is identified and accounted for.

2.2 Co-operation, horizontal and cartel agreements, bilateral agreements, alliances

2.2.1 Alliances

25. Airline alliances have become increasingly common in the airline industry. The Star Alliance is an alliance between a number of international airlines, and one of three major global airline alliances, others being Oneworld and Skyteam. In 2006, SAA applied for an exemption to join the Star Alliance. An exemption is written permission by the Commission to engage in a prohibited practice, should the application meet the criteria set out in the Competition Act.¹²

26. SAA sought the exemption for a period of ten years. SAA's exemption application was based on the fact that it was required for the maintenance or promotion of exports. After conducting its investigation, the Commission granted SAA an exemption for a period of five years on the basis that the exemption would indeed maintain or promote exports. In 2009, SAA applied for another exemption in respect of a new Star Alliance product called the Meeting Plus. The exemption was sought for a period of

¹² A firm can apply to the Commission to exempt an agreement or practice, or category of agreements or practices, from the application of the Competition Act, if the agreement or practice contributes to (1) maintenance or promotion of exports; (2) promotion of the ability of small businesses, or companies controlled or owned by historically disadvantaged persons, to become competitive; (3) change in productive capacity necessary to stop decline in an industry; and (4) the economic stability of any industry designated by the Minister of Trade and Industry, after consulting the Minister responsible for that industry.

10 years. Since the Commission had already granted SAA an exemption to join the Star Alliance and to participate in the provision of two similar products (the Convention Plus and Corporate Plus), the Commission granted SAA, a one year exemption so that the period for this exemption could coincide with the expiration of the initial exemption.

2.2.2 *Bilateral agreements*

27. In September 2012, SAA applied for an exemption to continue code sharing on Qantas operated flights between South Africa and Australia, for a further period of three years, from January 2013 to December 2015. The Commission had exempted the Code Share Agreement on five previous occasions (2000, 2002, 2005, 2007 and 2010).

28. Essentially, SAA requested that it be permitted to engage in the following activities; (1) coordinate its commercial passenger airline activities with Qantas in respect of the direct routes between South Africa and Australia; (2) allocate the market in terms of which SAA will operate on the route between Johannesburg and Perth, while Qantas will operate between Johannesburg and Sydney; and (3) acquire blocks of seats, in various classes, on each other's aircraft. SAA's application was based on the premise that the code share agreement was required to maintain or promote exports as well as to stop a decline in the industry. After, its investigation the Commission granted the exemption for a period of 18 months (from January 2013 to December 2014).

29. In November 2013, SAA applied for an exemption in respect of a codeshare agreement with Etihad on the route between Abu Dhabi and Johannesburg. The application is based on the fact that it is required for the maintenance and promotion of exports. SAA and Etihad seek this exemption for a period of five years. The Commission is currently evaluating this code share agreement.

2.2.3 *Horizontal and cartel agreements*

30. The Commission has investigated several horizontal agreements and cartel arrangements in the airline industry. Below we provide a summary the cases and settlements agreements that have been confirmed by the Competition Tribunal ("Tribunal").

i) Fixing of fuel surcharges and cargo rates

31. In July 2010, the Commission referred a complaint relating to the fixing of fuel surcharges and cargo rates in international airline freight services to the Tribunal for adjudication. This was a global cartel. The respondents in this matter were SAA Cargo, British Airways, Air France-KLM, Alitalia Cargo, Cargolux, Singapore Airlines, Martinair and Lufthansa. The airlines involved are all members of the International Air Transport Association (IATA), an international trade association for major passenger and cargo airlines established over sixty years ago.

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

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

ii) Far East Asia Complaint

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

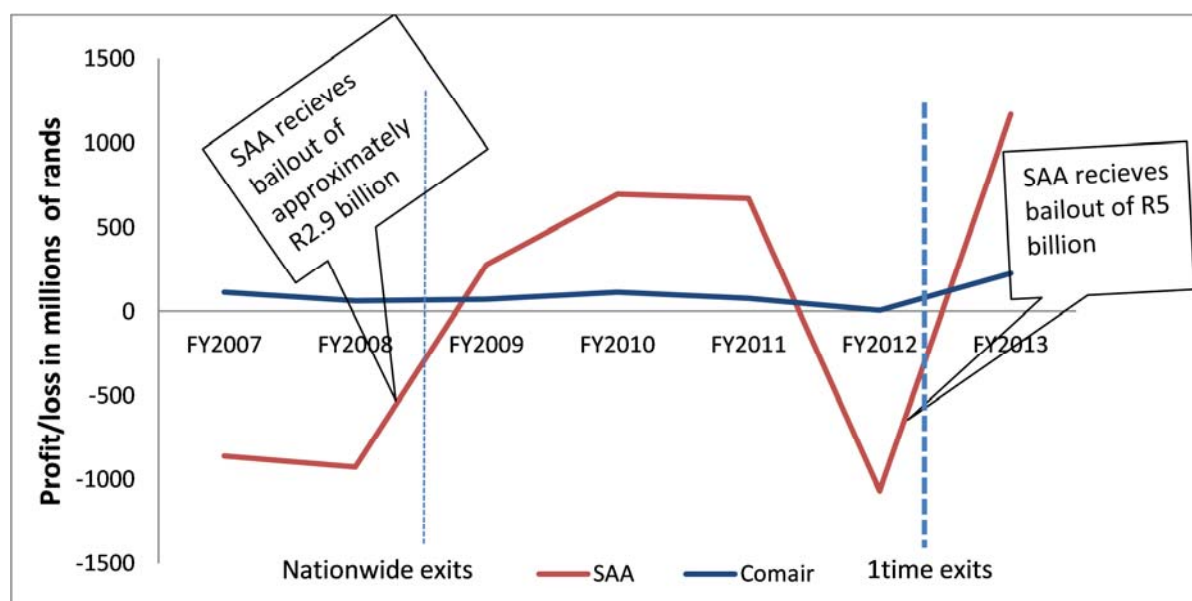
35. The Commission found that local representatives of the firms of the respondents in this matter engaged in discussions regarding air fare rates or prices in South Africa on several occasions during 2004, 2005 and ending February 2006. The discussions related to market fare levels and increases on certain market fares for flights out of South Africa to South East Asia, Hong Kong and China. Local representatives of the respondents relied on the content of these discussions among other considerations to determine fares and gain knowledge on competitor activities and price movements in the above stated routes.

36. Cathay Pacific received immunity for its role in the conduct as per the Commission's corporate leniency policy. Singapore Airlines and SAA have settled the case and paid administrative penalties for their participation in the conduct. In the case of SAA, this settlement agreement also settled cases against the airline in relation to collusion concerning international air cargo surcharges (above).

3. Financial distress and competition

37. Finally, we consider the potential effect of financial distress in the airline industry on competition in South Africa. Several airlines in South Africa have in recent years been making losses.

Figure 1: SAA's and Comair's profit/losses, FY 2007-2013



Source: SAA and Comair annual reports

38. Figure 1 shows the losses and profits that SAA and Comair incurred during the past seven financial years. It further shows state aid received by SAA during the same period. State aid to SAA has been in the form of concessionary financing and guarantees. For example, SAA applied for a R5.006 billion going concern guarantee from Government, which was approved by the Minister of Finance taking effect from 1 September 2012 to 30 September 2014 (the "Guarantee"). The Guarantee is subject to certain conditions, in that SAA should only use R1.544 billion to raise subordinated loans for working capital purposes and draw down against the remaining R3.362 billion to be contingent on the identified risks

materialising. The Guarantee reduces the cost of borrowing for SAA to below market levels and reduces the perceived risk to lenders.

39. The Commission has not assessed complaints relating to the exercise of public powers. Competition authorities cannot review any decision taken by Government Departments. Where the state exercises its power through a vehicle such as a firm, competition authorities have intervened. Perhaps what is needed is a framework that allows for a balance between the goals of correcting market failures, providing public goods and fostering economic development with possible inefficiencies and anti-competitive effects. While the Commission cannot investigate and evaluate decisions by other regulatory bodies or the exercise of public powers, the Commission can influence through advocacy and engagement with Government by raising awareness and advising the Government on the possible anti-competitive effects preferential treatment of state owned companies may have.

Reference

Federico, G. (2013), '*SAA II: Abuse of Dominance in the South African Skies*', *Journal of Competition Law and Economics*, 9(3), 709-737.

Luke, R & Walters, J. (2013) 'Overview of the Developments in the Domestic Airline Industry in South Africa since Market Deregulation. *Journal of Transport and Supply Chain Management*', 7(1) 1-11.