

Airtours/First Choice: CFI Holds Commission to Account

On the 6 June 2002, the Court of First Instance (CFI) issued its judgment on the Airtours/First Choice case, taking the dramatic and unprecedented step of annulling an EC Commission decision to prohibit a merger. In September 1999, the Commission had blocked the proposed acquisition of First Choice by Airtours on the grounds that the merger would have created collective dominance between the three largest suppliers of short-haul package holidays in the UK.¹ That decision was appealed to the CFI in early 2000.

1

This was the first time that the Commission had prohibited a merger on grounds of a collective dominant position existing between three firms. Previously, the Commission's collective dominance cases had involved two leading firms. For a more detailed critique of the Airtours decision, and a discussion of the relevant economic theory, see A. Lofaro and D. Ridyard, 2000, "The economic analysis of joint dominance under the EC Merger Regulation", *European Business Organization Law Review*, Vol. 1, pp 539-560.

The Court's Objections to the Commission's Analysis

In its judgment, the CFI sets out what can be essentially described as a three-step procedure for a finding of collective dominance in a merger case. First, each member of the alleged oligopoly group must have the ability to observe the behaviour of the other members. Second, deviation from the agreed mode of conduct must be discouraged by a credible threat of retaliation. Third, there should not be important constraints that are external to the oligopoly group – such as powerful customers, smaller competitors or the threat of new entry – which would be sufficient to destabilise any attempt at co-ordination by the market leaders. The judgment then goes on to test the Commission's decision against each of these three criteria, and finds fault in each area.

First objection: The Commission wrongly concluded that the characteristics of the package travel industry were conducive to firms reaching a tacit agreement.

The Commission had alleged that collective dominance would arise not in the setting of prices – since products were recognised as being highly differentiated – but in coordinated decisions to restrict the available capacity. While accepting that this collusive mechanism could work in theory, the CFI dismissed it mainly on the grounds that capacity is also heterogeneous, so that even a formal agreement to limit capacity would need to be specified over quite a complex range of variables. The fact that capacity decisions had to be determined some 18 months in advance of the sales period further undermined the likelihood of any coordinated behaviour.

Second objection: The retaliatory measures identified by the Commission could not be implemented quickly and effectively enough for them to act as adequate deterrents.

The Commission had argued that tacit coordination would be sustainable since there were a series of deterrents to any of the leading three firms deviating, the most important of which was the possibility that the other members of the oligopoly would flood the market with capacity for the following season, thus driving down prices and punishing the deviating firm. Several critics of the decision have noted that the Commission was very quick to assert that the parties would have an "incentive" to coordinate, but have questioned whether it adequately identified a mechanism whereby the merger would enable them to turn those incentives into actual uncompetitive behaviour, bearing in mind that there would also be incentives for each player to cheat. The CFI picked up on this absence of any robust co-ordinating mechanism. In particular, it argued that the scope for increasing capacity in the following season would be unlikely to discourage cheating with any credibility given the unpredictable way in which demand evolves from one

year to the next and the time needed to implement such a measure.

Third objection: The Commission underestimated the importance of factors external to the oligopoly group (mainly smaller tour operators and the threat of new entry) as a counterbalance capable of destabilising collusion.

The Commission had argued that external factors were not sufficient to prevent the exercise of collective dominance since, due to the alleged rapid increase in vertical integration implemented by the main package tour operators over the last few years, upstream into chartered airlines and downstream into retail distribution, smaller tour operators would not be able to compete effectively. The CFI dismisses such arguments pointing out that smaller players would still have plenty of post-merger alternative sources of supply of airline seats, and ready access to retail distribution. Even if barriers to mobility might prevent the smaller operators from growing to challenge the majors in terms of market share, the CFI felt that together they had the power to discipline any attempt by the oligopoly group to restrict supply.

The Assessment and Relevance of Pre-Merger Competition

The Court's three-stage approach sets out a useful framework for assessing whether a market is susceptible to coordinated effects, but a decision to block a merger on joint dominance grounds also requires the identification of some merger-related factor that will change the behaviour in the market towards greater coordination and less competitive outcomes. Helpfully, this point is acknowledged by the CFI at paragraph 82, which reads:

“If there is no significant change in the level of competition obtaining previously, the merger should be approved because it does not restrict competition.”

However, after setting out this critical requirement, the Court is less convincing in its criticism of the Commission's assessment of pre-merger competition, or in its explanation of the factors that should guide the analysis on this aspect.

For collective dominance to be created or strengthened, there must be some point at which a merger transforms a (relatively) competitive market into a (relatively) uncompetitive one. This implies that the competitiveness of the pre-merger market cannot be decisive. On the other hand, it is intuitive that the more competitive the market is pre-merger, the more dramatic the change arising from the merger has to be to justify the collective dominance finding.

The problem the Commission had in this case is that, as recently as December 1997, an MMC inquiry had concluded that this was a fiercely competitive industry with no barriers to entry or expansion. Unless the nature of competition had changed in the two years that had elapsed between the MMC verdict and the proposed Airtours/First Choice merger, then the change required for the merger to lead to a position of collective dominance would have been huge.

The Commission did however set out a plausible story to suggest that the market had undergone a change in character in this period, and which implied that the industry's past dynamic behaviour might not be a good guide to the future.² In support of its position, the Commission cited the increase in vertical integration, the stability of market shares, and the fact that the market had polarised into one with four (soon to become three) large integrated payers and hundreds of small un-integrated players, with nothing in between.

The CFI delivered a scathing criticism of the Commission's reasoning on these points, but in doing so it seems to have gone further in its criticisms than is justified and to have lost sight of the relevance of pre-merger competition for the assessment of collective dominance. For example, the CFI asserted that vertical integration is pro-competitive because it limits the interdependence of large tour operators. However, this does not

2

For example, the 1989 inquiry by the MMC into the merger between Thomson and Horizon reported Airtours' market share at just 3% and Thomas Cook (the other member of the oligopoly group in 1999) at 2%.

invalidate the Commission's view that vertical integration had raised the stakes such that only the integrated majors could contest market leadership in the new environment, and that small operators would now be prevented from growing rapidly to a size comparable to that of the majors.

Similarly, on polarisation the CFI argued that the new barriers to mobility did not prevent the small players collectively posing a threat to the majors. This is a potentially valid point, and one that rests on the facts, but it is a different kind of mechanism from the one that had acted in the past, where the real threat of dramatic growth from a base of zero, by players like Airtours, acted as a direct and tangible constraint on the leading players. It was therefore not unreasonable for the Commission to base its "change in competition" story on this element.

The sense that the CFI overplayed its hand in its criticisms on the pre-merger situation (and of its relevance) risks sending confusing signals for future cases. It does not, however, undermine the judgment. The Court's outright rejection of the Commission's case on the likelihood of post-merger coordination is robust: the Commission completely mischaracterised the nature of demand volatility, it did not identify a reasonable enforcement mechanism, and it failed to appreciate the force of the competitive fringe as well as other external constraints. These factors combined are enough to dismiss with confidence the possibility of post-merger collusion.

What Implications for collective dominance cases?

As regards the assessment of collective dominance, the Airtours/First Choice judgment is important for two reasons.

First, the CFI has not rejected a priori the somewhat novel theory of collective dominance put forward by the Commission in the Airtours/First Choice decision, namely collusion in the setting of capacity followed by normal competition in prices. On the contrary, it has implicitly accepted that this collusive mechanism is based on some potentially plausible economic models of tacit collusion, and re-affirmed that the Merger Regulation can be used to deal with collective dominance concerns.³ The failure of the Commission's case lay in its treatment of the facts, not the theory. The CFI concluded that the Commission's economic analysis in this case had been inadequate and "vitiating by a series of errors of assessment".⁴

Second, the judgment articulates a useful analytical framework for assessing collective dominance concerns. That framework should help focus attention on the key issues identified by economic theory that determine whether a particular merger raises collective dominance concerns. The three-step procedure identified by the CFI – assessment of transparency, retaliation possibilities and external constraints – represents an important improvement on the checklist approach commonly used by the Commission. This is because very rarely will an industry either satisfy or violate all the tests in the Commission's checklist. In the great majority of cases, some of the conditions will hold while others will be absent, leaving the Commission with a great deal of discretion as to which factors should be relied upon in that particular circumstance. Under the CFI's suggested framework, it is clear that if any one of the three identified conditions fails to hold, then post-merger tacit collusion should be automatically ruled out. This ought to improve the clarity of analysis in this difficult area.

The framework put forward by the Court also has the effect of drawing a helpful comparison between the assessment of collective dominance and that of single dominance. Indeed, while the first two conditions in the CFI's collective dominance test – market transparency and retaliation possibilities – imply that the alleged oligopoly group should be able to behave as one single entity, the third condition requires the oligopoly group collectively

3

The collusive mechanism identified by the Commission is what economists call semi-collusion. See, for example Fershtman and Gandal, 1994, "Disadvantageous Semicollusion", *International Journal of Industrial Organization*, Vol 12, pp 141-154.

4

Paragraph 294.

to enjoy a dominant position, i.e. to be able to increase prices above their current level without being sufficiently constrained by external factors. The analysis required in this last stage, comprising an assessment of the ease of entry, the ability of smaller competitors to react to a post-merger price increase, and the ability of large buyers to countervail the market power of the oligopoly group, is similar to the analysis necessary to assess whether significant unilateral effects are likely under single firm dominance concerns.

Wider implications?

It is difficult to predict today whether or how the CFI's judgment will improve the Commission's analysis in future merger decisions. Through this judgment, the Commission has been officially warned that unless it tests its theory of competitive harm meticulously against the facts, it can expect a very hard time from the CFI should the parties decide to appeal. It is noteworthy and heartening that the CFI has shown itself to be fully prepared to immerse itself in the detail of the economic evidence, and to reprimand the Commission on its failure to appraise the substantive issues. This approach is much more robust than that found in judicial review of UK merger decisions by the Competition Commission, for example.

It is too early to conclude, however, that the Commission is now subject to an effective appeal mechanism. Airtours' commercial opportunity to acquire First Choice now appears to have passed, and in consequence the CFI judgment represents mainly a symbolic victory for Airtours. As long as the CFI continues to play its current role of examining Commission decisions so long after the event, the CFI will not provide an adequate appeals mechanism unless it has the indirect effect of embarrassing the Commission into making its decisions more robust. The introduction of a fast track procedure, although welcome, does not substantially alter that conclusion.

Given the CFI's evident dissatisfaction with the Commission's analysis in the Airtours/First Choice decision, it will be interesting to see how the much criticised GE/Honeywell, Schneider/Legrand and TetraLaval/Sidel decisions will stand up to the scrutiny of the CFI in the on-going appeals on these cases. The real significance of the Airtours/First Choice judgment, however, will lie in the way in which it influences the rigour of the Commission's economic analysis in future merger decisions.