Competition Policy in International Airline Markets: An Agenda and a Proposed Solution

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ABSTRACT

This paper considers recent developments in the markets for international airline services, especially considering new entry, mergers and alliances, and the lack of effective international regulatory policies and institutions to deal with them. It emphasises the importance of designing efficient competition policy and enforcement procedures in markets where networking is important. The present regulatory efforts (or the lack of them) are the result of historical actions at national, bilateral, regional and multilateral levels. Airlines have engaged in a variety of forms of self-regulation in an attempt to make their market environments work better. The more that such practices become entrenched, the harder it will be for new policies to produce first-best regulatory outcomes. The paper considers a number of possible policy scenarios for promoting competition in international airline markets, and concludes that in the interests of global airline regulatory efficiency, it is time to consider the development of a converged international policy covering competition between airlines.

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1. Introduction

Few major airlines operate in a purely domestic environment. More so than most areas of business, airlines work on an international scale, with most of them flying at least to adjoining countries. However, while many international airlines pursue global strategies, their regulation is still largely national. Local regulators control firms in their jurisdiction in a vacuum, not usually taking into account the firms' operations and their economic spillovers (good or bad) elsewhere. In reality it is not possible for one economy to successfully regulate a multinational airline, as decisions will likely be made in favour of local welfare, which may not correspond with either the firm's private optimum or with the international socially optimum outcome. Just as sector-specific competition policies within a given country can lead to regulatory inconsistencies and potential for capture, then also uncompromising country-specific competition policies may stand in the way of achieving regional or global consensus and the benefits that can follow from harmonised approaches to making markets work competitively. This is especially true when dealing with sectors exhibiting strong network effects.

Mergers and alliances between airlines can provide benefits to all participants. Through them airlines can become more efficient and offer better price-product-service packages to passengers and those organisations seeking timely delivery of freight. However, airline mergers and alliances cannot be evaluated fully within a purely national framework. They must be evaluated in a global rather than in a local context.

We believe that an integrated international policy position on promoting competition in air transport markets is valuable. Piecemeal, uncoordinated developments in competition policy and enforcement in international airline markets will not lead to a global optimum and will result in conflicting outcomes as well as in static and dynamic inefficiencies.

In this paper we present a brief consideration of the regulatory environment and of recent dynamic developments in the sector, especially with respect to mergers and alliances. History tells us that regional or international policy initiatives are never easy or conclusive. Qantas' and Air New Zealand's trans-Tasman experience between 2003 and 2005 is highlighted as a case study.

Discussion then follows on regulatory errors. We argue that a global authority is less likely to make decisions that are globally welfare-reducing than can happen with separate national authorities. We note that dealing only with one regulator significantly lowers firms' costs of complying with competition laws. This raises the question of institutions – their nature, form, location, power, transparency, accountability, responsibilities and goals. The creation of a truly international airline regulatory policy and enforcement regime will take time. We discuss some possible transitional paths before concluding with suggestions as to how, when and by whom an agenda for a truly international airline competition policy framework can be developed.

2. Mergers and alliances in airline markets

The 'three pillars of stagnation' is a phrase coined by Giovanni Bisignani, Director General of the International Air Transport Association, to describe the bilateral system of exchanging air transport traffic rights, national ownership rules, and the approaches taken by competition authorities. In his view these three factors limit change and profit prospects in international air transport markets.[1]

The regulation of international air transport services involves a complex web of over 3500 bilateral agreements that establish rules to identify the airlines that can be designated to fly on each route, determine the capacity that they can deploy, and limit the capacity that can be offered by airlines from third countries. Rights of designation usually depend on local ownership and control, which constrain the scope for mergers across international borders. The system imposes country-specific quotas in each country-to-country market pair, and competition on each route is limited to those suppliers designated by the relevant bilateral agreement.[2] As a result of these restrictive entry conditions, some carriers earn substantial profits on some routes, but this is far from a universal condition, and so it is claimed that regulation is not working, and reforms are urgently needed.

The regulatory system itself has also increased the airlines' costs. They have been forced to construct networks through a maze of bilateral agreements. These can in part be overcome through alliances and code sharing but this is likely to be a second-best solution.[3] Some routes are undoubtedly being served inefficiently because of limitations on market access associated with bilateral agreements.

In the last decade airline markets have witnessed a flurry of corporate restructuring, horizontal and vertical integration and diversification through internal or external growth, and through consensual amalgamations and alliances. Some mergers have been approved by competition authorities, both within countries as well as in a regional setting, such as the Air France/KLM and Lufthansa/Swissair amalgamations. Air France/KLM had expressed interested in Alitalia (that plan collapsed in April 2008) and Alitalia might now merge with Air One (Italy's second largest carrier) instead. The Lufthansa/Swissair group is reported to be seeking Austrian Airlines, as is Russian airline S7. In the US, Northwest is in the process of taking over Delta. Other proposals have been blocked: Rynair's bid for Aer Lingus was blocked last year by EU competition authorities. Yet more proposals are under discussion: in Europe Lufthansa is in talks to purchase SAS and there are reports of closer links between BA, American and Iberia. Singapore tried but failed to take over China Eastern in January this year. Airline executives are referring to further consolidation as 'inevitable': Zhang and Round (2008) examine a burst of mergers in the Chinese market in 2002 following domestic deregulation.

Some alliances have not been approved, at least consistently between jurisdictions, as in the attempt by Qantas and Air New Zealand to form a formal and comprehensive trans-Tasman alliance in 2003.[4] Other alliances, for example between Qantas and British Airways on the so-called 'kangaroo route' from Australia to England have been approved (twice in this case, the most recent approval occurring in 2004) on public benefit grounds. In this case their combined market share was a much lower 40 percent (compared with the approximately 80 percent combined market share of Qantas and Air New Zealand across the Tasman), and the two airlines faced real competitive constraints from Singapore Airlines and Emirates, among others on the route.

[1] https://iata.org/pressroom/speeches/2003-03-22-01 (accessed 15 September 2008). Findlay and Round (2006) consider the challenges for air transport reforms that are posed by these three pillars.
[2] Descriptions of the system are provided by the Productivity Commission (1998) and WTO (2000 and 2001a).
[3] Cooperative arrangements between carriers are reviewed in WTO (2001b). Oum, Park and Zhang (2000) provide an analysis of alliances.
[4] More recently Virgin Blue has been presented as a merger partner for Air New Zealand.

There appears to be little doubt that such corporate activity has been privately beneficial. Executives have argued that the Air France-KLM merger had been a success as the separate brands had been retained (but customers could combine fares from both), and because the two airlines had largely operated complementary networks.[5] It has also been argued that the success showed that mergers were not just a matter of cutting routes, but could lead to real synergies, and that the model of the future could be one bottom line with two brands and two networks, but with inter-operable networks.

In the presence of restrictions on foreign ownership and the bilateral regulatory system that governs international airline operations, which together give limited access to country-pair traffic rights, cross-border amalgamations such as those that have occurred in Europe are unlikely to feature strongly in the medium term. Brand franchising may occur, and alliances are another way to get some of the advantages of a merger. Code sharing can work too, in so far as brand presence is achieved on a route, or as in the operating alliance that had been proposed by Qantas and Air New Zealand, whereby the two airlines would each have been able to maintain a full network presence while eliminating some of the excess capacity (thereby gaining more efficient use of aircraft) that is a feature of the trans-Tasman market.[6]

Freedom to merge or form alliances gives airlines greater ability to respond to market forces, yet with these greater freedoms there would likely be calls for attention to competition issues including, inter alia, entry conditions, mergers, and the use of market power.

Bisignani, however, has argued that competition authorities are too cautious. He has referred to ‘dogmatic competition policies [that] also restrict our freedom’. He observes that despite the existence of strong competitive forces in these markets, including LCCs and fifth freedom operators, decisions on mergers or alliances by single-country regulators take much time and that competition authorities everywhere are over-cautious with air transport. He asks:

> What other global business is more fragmented than air transport? Where are the multi-national players, the Daimler-Chrysler's or the Pharmacia-Upjohn's of air transport? Some industries requiring large investments are fiercely competitive even with just a few very large players. In spite of that, most airline alliance projects, or the few merger attempts face long delays. …We need the economies of scales [sic] that mergers or acquisitions can provide with the proper competition supervision . . . the regulators must take up the challenge of change![7]

Some caution may however be warranted, not just because of the effects of mergers on concentration in air transport markets, but since the effects of all these types of conduct transcend national boundaries.

If regulation occurs through an uncoordinated network of national authorities, and mergers are denied, airlines will develop strategies to capture the gains from networking, including alliances with airlines based in other countries. That is, as noted earlier, they will respond to

[5] Interview in *The Australian*, April 29, 2006, Patrick Alexandre, the executive vice-president of the international commercial division of Air France. The Air France/KLM amalgamation aimed for cost savings from many sources, including combining local and regional management teams, joint ticket counters, joint airport handling contracts, shared airport lounges, and renegotiated catering contracts.

[6] Their LCC subsidiaries appeared not to have been included in the code-sharing proposals, but would abide by some form of agreement that would eliminate fierce competition. If the proposal had been authorised by the Australian Competition and Consumer Commission, the airlines would have coordinated pricing and marketing initiatives as well, in the process eliminating the losses that have emerged in this sector due to too much capacity and heavy discounting by new entrants. It was estimated in April 2006 that there were 3120 vacant seats every day on trans-Tasman flights. See Rod Myer, ‘Qantas, Air NZ try to mop up spare Tasman seats’, *Sydney Morning Herald*, 21 April 2006.

[7] https://iata.org/pressroom/speeches/2003-03-22-01 (accessed 15 September 2008).

policy decisions and seek to re-engineer their operations and institutional environment in their own self-interest. From an overall social perspective, these responses and the initiating policies may well be second-best outcomes. Here, the gains from consolidation are not lost but are attenuated through a less socially-optimal regulatory regime.

The alternative, providing for a regional or global airline merger authority, will produce the opposite set of outcomes, generating social efficiency gains but in all likelihood creating national concerns about competition effects and damage to national champions. It is unlikely that the long-run first-best option for an international regime for transport competition policy will be immediately achievable. History will work against that. But having adopted such a policy goal, we can consider various strategic paths for its implementation. The first steps may have to be small ones. It is important to get the culture for competition right, before moving on. One step at a time is better than two steps forward and one step back. Evenett (2005, p. 17) stresses the value of such an approach in his discussion of recognising the implications of cross-border spillovers:

> Competition enforcement agencies may see advantages in coordinating and sequencing investigations, and even in specializing in certain types of investigations, much in the same way that certain national competition law enforcement agencies in the same jurisdiction cooperate with one another. Arguably the current discussions on international cooperation on competition law and enforcement are a long way from this type of outcome, but the goal [should be] not to show what is practicable immediately but where the logic of internalizing cross-border spillovers leads to in terms of international collective action.

We return to the sequencing of reform in later sections, but first illustrate the issues in uncoordinated action in a case study of decision making across the Tasman.

3. Intersection of regional and domestic policies: a trans-Tasman case study

Currently, with the exception of the EU, cross-border mergers between firms domiciled in different countries are independently assessed in their respective countries. Mergers are evaluated under each country's statutory provisions, which demand assessment in terms of national priorities and objectives. Even in geographically, commercially and culturally close countries like Australia and New Zealand that over the past decade have signed several MOUs on the harmonisation of trans-Tasman business laws,[8] the statutory objectives of enhancing national welfare are squarely national, not trans-Tasman. The competition authorities from the two countries meet frequently, undertake staff exchanges, use similar guidelines, and cooperate in investigations and coordinated enforcement where appropriate. Yet there are significant differences in analytical approaches, in attitudes to public consultation, in attempts to quantify anti-competitive detriments and public benefits, and in the welfare standards used to assess 'public' benefits. In addition, differing appeal procedures and decision making authority mean that complete business law harmony is far from being achieved.[9]

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[8] See Round et al. (2006) for details on these MOUs. For example, a company with a substantial degree of power in a trans-Tasman market (one with a geographic dimension of either within Australia, or New Zealand, or both) must not take advantage of that power for one of three proscribed anti-competitive purposes in any market in either Australia or New Zealand. A misuse of market power in any market in the two countries can be attacked by the competition agency of either country in its own court system.

[9] In a press release dated 23 July 2006, the Australian Competition and Consumer Commission and the New Zealand Commerce Commission announced an in-principle agreement to a protocol to enhance their cooperation in dealing with trans-Tasman mergers, including the sharing of information, assistance with merger reviews and

The problems of multiple merger jurisdictions are strikingly demonstrated by the competition regimes of Australia and New Zealand. Both countries prohibit mergers that have the purpose, effect or likely effect of substantially lessening competition. Agreements, arrangements or understandings between competitors are similarly proscribed. A somewhat unique feature of the *Trade Practices Act* in Australia and the *Commerce Act* in New Zealand is that both types of conduct can be administratively authorised (rendered immune from prosecution) if the parties can demonstrate ex-ante that any anti-competitive detriments arising from the conduct will be outweighed by any public benefits directly attributable to it. This process can be lengthy and cause significant commercial delays. If the parties are domiciled in separate countries, the authorisation process has to be undertaken in each one separately. Despite essentially the same law being applied to the same set of facts, different outcomes can result.

Nowhere has this been more starkly demonstrated than in the attempt that began in 2002 by Qantas and Air New Zealand to set up a trans-Tasman agreement whereby the two airlines would coordinate schedules and pricing for all flights within, originating from, and arriving into the two countries. Qantas also sought to acquire a 22 percent stake in the equity of Air New Zealand. The proposals were denied by the Australian Competition and Consumer Commission (ACCC) and by the Commerce Commission in New Zealand on largely structural grounds, based on a likely combined trans-Tasman market share of around 85-90 per cent (Air New Zealand did not fly domestic routes in Australia, and appeared unlikely ever to do so, and Qantas operated only very limited services within New Zealand, and appeared to have no wish to expand these).[10] Qantas and Air New Zealand appealed both decisions to the relevant appeal bodies, the Australian Competition Tribunal in Australia,[11] and the High Court in New Zealand. The appeal was denied in New Zealand, but was granted in Australia. The proposals were abandoned, however, at least temporarily, as they needed approval in both jurisdictions.

Why was it that the two regulators agreed, but the appeal authorities produced quite different decisions? The problem lay in the differing nature of the appeal procedures. In Australia, the appeal was to the Tribunal, a body consisting of a judge of the Federal Court of Australia as President, and two lay members appointed for their expertise in commercial matters, economics or the law. For appeals on agreements and equity acquisition issues, the process is a de novo one (rather than a review on the papers that were before the ACCC) in which a complete rehearing occurs, with updated evidence, new witnesses, and new arguments and submissions being heard. For New Zealand, the appeal was before the High Court of New Zealand, in which a judge sat with one lay member, with only limited admission of new evidence, the purpose of the appeal being to determine whether the Commerce Commission had made error in its decision.

In a market which was highly dynamic, it came as no great surprise that the two appeal authorities handed down quite different decisions. In the intervening period between the regulators' decisions and the appeal hearings, the market for passenger flights between Australia and New Zealand had changed markedly. Significant new entry had occurred by Virgin Blue, an Australian carrier, and Emirates, a large international carrier that used its

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the synchronization of their timing, and the gathering of information on behalf of each other. See http://www.accc.gov.au/content/index.phtml/itemId/754797/fromItemId/142, accessed 15 September 2008.

[10] It is the normal practice of the ACCC not to oppose mergers, even if they will result in a duopoly, if there is evidence of sustained and sustainable levels of import competition.

[11] David Round is a Member of the Australian Competition Tribunal, and was one of the three Members who sat on the appeal. Nothing that is said in this paper, in general or specifically in relation to this appeal, should be ascribed to the Tribunal, but rather should be read as his personal views.

'dead' turnaround time to fly a return leg across the Tasman. Both airlines offered much lower fares (and, in the case of Emirates, true international class service) than had previously been charged by Qantas and Air New Zealand, resulting in a steep drop in market share for the two established carriers.

Using a behavioural rather than a structural approach (in contrast to the ACCC at first instance, which focussed heavily on market shares), the Tribunal found that in the presence of such fierce competition, there could be little prospect of future anti-competitive detriment, as it would not be in the commercial interests of Qantas and Air New Zealand to raise their prices or significantly restrict their schedules,[12] in the face of these low priced entrants that appeared to be committed to the trans-Tasman market in the long term, and for whom there appeared to be no barriers to expansion.

In contrast, in New Zealand the High Court sought to find whether there was any error in the findings of the Commerce Commission, paying little regard to developments in the market, especially with respect to new entry. In authorisation matters, New Zealand has generally sought a greater level of quantification of anti-competitive detriments and public benefits than has been the case in Australia, and, while the Court did find some errors that worked to the airlines' advantage, they were not sufficient to lead to a reversal of the regulator's decision. A further appeal was open to the airlines, but they chose not to take this opportunity.[13]

Following their failure to get the arrangements approved, it appeared that each airline would go its own way, with Qantas in particular focussing on LCC operations in Asia. However, in April 2006 the two airlines submitted a new proposal to the ACCC for authorisation, in the form of a trans-Tasman code-sharing alliance that controlled capacity and prices. This application relied on the findings of the Tribunal, and effectively by-passed the Commerce Commission, as in New Zealand inter-country airline agreements (the new proposal contained no equity acquisition component) need only to get the approval of the Minister for Transport, who had supported the previous set of proposals as the relevant Minister (but who of course had no control over the independent Commerce Commission). On the assumption that such approval should now be a 'shoe-in',[14] the two airlines presumably decided that they could apply to the ACCC for authorisation, confident that even if the application were to be rejected, in the face of what is now a highly competitive trans-Tasman airline passenger (and freight) market, any appeal would likely still find favour with the Tribunal. However, early in November 2006, the ACCC issued a draft decision rejecting this new application, and it was announced shortly thereafter by the airlines that they would not proceed with yet another appeal.

The moral of the trans-Tasman position is clear. For internationally traded goods or services like country-to-country airline services, within-country assessments of commercial activities may differ significantly from country to country, with the potential to disrupt or deny globally or regionally efficient strategies from coming into operation. An unduly restrictive statute is likely to damage welfare, especially when dealing with industries where network effects are

[12] Some readjustment of schedules had been proposed by the airlines in order to eliminate wasteful wingtip flying and to introduce aircraft of optimum capacity for each flight, rather than continue with the inefficient scheduling of parallel flights and large aircraft resulting in excess capacity.

[13] It is worth noting that New Zealand appeal authorities have always been reluctant to find against the Commerce Commission, on the grounds that it is a specialist regulatory body with the knowledge and ability to investigate and analyse commercial matters.

[14] Warren Truss, the New Zealand Minister for Transport, was reported in *The Australian* on June 15 2006 as saying that the proposed new agreement between Qantas and Air New Zealand would help both airlines bring about needed capacity rationalisation, helping them to survive in a very competitive market in which they had been losing market share.

important, and where the firms subject to the vagaries of introspective regulation have the commercial opportunity to choose other locations in which to base their operations or to locate part of their commercial network.

4. Regulatory errors and multiple competition authorities

As illustrated in the previous section, when firms located in two different jurisdictions seek to merge or engage in an alliance, two independent regulators will assess the conduct. In markets that are as interconnected as airline markets, decisions on the competitive process by one country will almost certainly affect competition in airline markets in other countries. Findlay and Round (2003) have observed that different decisions could emerge between countries on a merger, either for reasons of political economy, or because of differences in regulatory capacity or maturity or methodology or investigatory procedures, or because of different attitudes taken to the costs of decision errors. Regulators may also come to different conclusions because of differences in data provided to them (certainly this was the case in the Qantas-Air New Zealand alliance application). But most importantly for the purposes of this paper, each regulator will examine the impact of a proposed merger or alliance on the welfare of its own country's population and the firms domiciled in that country (or the share of profits accruing to its nationals if the firm is partly foreign owned). If benefits or costs accrue to foreign nationals, they will not normally be considered.

Under this scenario, for a proposal to go ahead it must be approved by both regulators. Under what circumstances could one regulator accept a merger application while the other rejects it? More to the point, could a proposed merger that reduces global welfare be accepted, or could one that improves global welfare be rejected due to its assessed impact in one country? Many academic papers have considered these kinds of issues. National authorities that concentrate on the effect of mergers on national welfare will usually overlook the possibility that such mergers could have an effect on producer surplus accruing to foreign firms, and could result in increased prices in international markets – external effects not within the country in question, but in other countries.[15]

Tay and Willmann (2005) model mergers as random events that yield asymmetric consequences in the two countries affected by them. They conclude that a first best global competition policy can only be achieved through a global competition authority that can internalise cross-border externalities, and point out that such an authority would free poorer countries from the expense of setting up their own independent competition authority. Haufler and Nielsen (2005) use a Cournot model also to show that under certain circumstances actions taken by national merger authorities towards national mergers will be too restrictive from the perspective of global efficiency. They argue (at p. 25) that there is

> an important asymmetry between national and cross-border mergers in markets where national players dominate. In these markets a national merger will indeed reduce the number of firms that actively supply the market, whereas an international merger will not . . . the conditions for an international merger to be in the interest of the participating firms are unambiguously stricter than in the case of a national merger, but when indeed proposed, international mergers will not be vetoed by neither [sic] national nor regional merger authorities.

Findlay and Round (2003) have assessed regulatory discordance in the context of two sources of conflict between regulators: differences in structures between the two economies and the resultant differing weights given by regulators to consumer and producer interests, and

[15] There is a considerable literature now on these external effects. See, for example, Farrell and Shapiro (1990), Barros and Cabral (1994), and Head and Ries (1997).

different approaches to the need to look forward in the assessments and how to handle the ensuing uncertainty that emerges in any assessment of dynamic market efficiency.

Differences in reactions by regulators to merger proposals can arise because of differences in the structures of their own economies. From a global perspective a merger proposal should be rejected if it reduces total welfare - that is, if the expected loss of consumer surplus exceeds the likely gain in producer surplus. But each regulator will make this assessment according to its own views on the appropriate measurement, and the relative distribution, of these surpluses. One country, for example, could account for a relatively high share of producer interests and a relatively low share of consumer interests and would discount the total cost to consumers and take into account a greater share of the impact of the proposal on producers. It is possible for such a country to approve a proposal which does not enhance global welfare as its large share of a relatively small gain to producers exceeds the cost to its consumers, and that when this happens, the other country (in a two country world) will reject the same proposal. If approval by both regulators is required, the merger would not go ahead, avoiding the risk that global welfare will be reduced. Additionally, a merger that increases global welfare could be rejected by one country if its loss in consumer welfare is relatively large compared to its share of producer gains.

Clearly, it is possible that one country could be worse off when a merger that reduces global welfare is rejected, but it is unlikely that a scheme could be set up to compensate that country. In contrast, if a country seeks to stop a merger that enhances global welfare, compensation may be feasible, although it would need to be checked that this country was not ‘gaming’ the situation. Establishing such a scheme would be costly, however, and the assessment of the appropriate compensation would not be easy, especially in view of the possible long-term incentive effects.

All regulatory decisions are subject to the possibility of error. Type 1 error occurs when a merger that will be welfare enhancing is rejected, while Type 2 error results from the approval of a socially undesirable merger. Here, it may be hard to undo the damage, as once the eggs have been scrambled it will rarely be possible to revert to the original position. However, if a Type 1 error is made the proposal can always be resubmitted, with no lasting social (or private) damage. Type 1 and Type 2 errors are inversely related; any regulatory scheme to reduce the probability of one occurring automatically increases the chance of the other taking place. Avoiding the risk of accepting a merger that will reduce welfare means that that there will occur a greater rejection rate of all mergers, good as well as bad. The trade-offs can be reflected in the threshold that is applied in the statute. For example, the higher the threshold for rejecting a merger (an easier regime), the greater the implied risk of making a Type 2 error. Findlay and Round (2003) note that in open economies with few entry barriers, Type 2 errors may correct themselves over time, as any excessive profits made as a result of the increased market power will encourage entry into the market. While Type 1 errors may only entail short run social costs, they will involve irretrievable losses to both consumers and the firms involved. To guard against this situation becoming a long run problem, firms must be able to re-apply, or appeal to an independent review body for a speedy rehearing of the case.

In airline markets, where entry possibilities are often closed off by other regulations, the consequences of making a Type 2 error could be damaging, and so regulators should investigate merger proposals in great detail, and may be more likely to reject mergers that increase competition. Depending on national goals and stages of development, and on the relative short-run and long-run costs of these errors (and on the costs of reducing them), different countries may evaluate the consequences of the two different errors in different ways. Such inter-country differences create major problems for cooperation on competition policy issues.

When two countries assess a merger independently and when agreement by both is required before a merger can go ahead, the country which is more concerned about a Type 2 error (and therefore will be more likely to reject an application) is likely to prevail and determine the final outcome. Such a country is likely to be at a later stage of development, or to have a stronger antipathy towards big business, or to have a longer established culture for competition, or to regard entry barriers as being relatively high.

If regulators follow different ideological approaches to assessing the competitive process further opportunities arise for different decisions. For example, one regulator might favour a structural approach and the other a dynamic approach that focuses on strategic behaviour by firms.[16] This situation might arise as between a relatively new regulator and an experienced one. A regulator following a strategic behaviour approach may approve more mergers than one following a structuralist approach. The gap could be expected to diminish over time, and consultation, cooperation and capacity building clearly will help produce a more coordinated regulatory vision, but, even so, discrepancies in the positions of the regulators could persist, to the detriment of firms that wish to merge and to society in general.

The message here is unequivocal – the 'right' answer on mergers and alliances, globally speaking, and assuming that the goal will always be to maximise total welfare, is more likely to happen when these kinds of conduct are assessed by a supranational authority. For this to occur, individual countries need to yield their legislative and decision-making power to a more widely-based constituency. More globally socially efficient decisions will then be likely, but problems relating to distributional equity between countries will be inevitable.

5. Steps towards a multilateral competition policy for airline markets

The idea of an international competition policy and a global 'super-regulator' for competition and consumer protection issues is not new. [17] A move towards a single authority is still far from being a reality, if for no reason other than we do not know what the objective functions of the respective national authorities are.[18] The gains from setting up such a body would in all

[16] As was the case in the evaluation of the Qantas-Air New Zealand alliance in Australia, where the ACCC took largely a structural approach, and the Australian Competition Tribunal on appeal favoured an analytical method based on the examination of strategic behaviour in the relevant markets.

[17] For an interesting early assessment of the need for competition policies for an integrated world economy, and a proposal for international competition policy instruments that would seek to promote competition while at the same time having a low impact on national sovereignty, see Scherer (1994). It is interesting to note Scherer's final sentence in his book: "It is important to emphasize that extraterritorial application of domestic antitrust law must be a solution of last resort so as to place a priority on promoting cohesive and converging competition policies in an increasingly international market."

[18] Many issues need to be agreed on before such an authority can be successfully established. For example, should it be bureaucratic, administrative or judicial? Should it operate under a current international body or start afresh? What will be the national composition of the authority? Will membership (and will it be legal, other professions, or business people, and in what proportions) rotate, and if so, how often? How will the chair of the authority be selected, and what tenure will this person have? To what superior authority or institution will the group report? What will be the nature (legal or administrative) of the review/appeal stage of the process, and on what grounds will appeals be heard? Should its procedures be inquisitorial or adversarial? Agreement is also needed on whether the objective should be efficiency in airline markets – allocative, productive and dynamic, or whether equity issues should be given much weight. As western countries with a long experience of competition policy have not in the past necessarily agreed on these objectives (Europe, for example, has tended to favour the latter while the US has generally emphasised the former), it is unlikely that ready multinational agreement will occur on these goals.

likelihood not be distributed evenly, and would be especially likely to fall to countries which do not already enjoy extraterritorial powers. In the absence of a mechanism for compensation or side payments, such a body will be difficult to establish with any sort of universal support. The benefits from embracing a competitive culture, however, are likely to be so high that the winners could in theory compensate the losers (an equity argument rather than an efficiency one), and there would still be a credit balance left at the end of the process. In practice, of course, such processes do not happen, as there is no mechanism that can easily be used to bring about this redistribution.

Countries should of course be free to choose the competition policy they think is locally optimal – but they must be conscious of any spillovers to other countries from their decisions. At the very least there should be some consistency in national laws on the worst anticompetitive practices, but different economies at different stages of economic development will always face different problems with respect to competition policy.

Our interest here has been the treatment of competition issues in international airline markets. There is a an argument that multi-purpose regulators are generally preferable to single-sector regulators as they present less opportunity for regulatory capture, and promise greater consistency in assessment of all types of conduct and all kinds of markets. From a cross-border perspective, a trade-off also exists between having a single regulator, perhaps lacking detailed knowledge of each relevant economy, and the more specific expertise of single-country regulators. From this, one might conclude therefore that a transnational, single-market authority dealing with airlines is subject to major organisational as well as operational difficulties – treating issues in an inconsistent way with other antitrust authorities, being subject to capture. Yet it does offer the prospect of proper consideration of all the network-wide effects of airline behaviour, and of internal consistency in evaluating airline behaviour.

Our suggestion is that, first, a commitment to the principle should be sought. It will be much harder to reach agreement on the detail.[19] Such cooperation, albeit limited, would be an improvement on the current situation of uncoordinated and unsystematic attempts to control mergers, especially cross-border amalgamations. Agreement would be needed on many issues – the type, focus, detail and coverage of the laws, as well as the degree of proscription and prescription; the nature of enforcement; and the penalties that could be incurred for breaches of the statute. As Round (2005, p. 239) has said in relation to the need for East Asian countries to develop a harmonised approach to competition law and policy:

> The pursuit of a cooperative regional policy and enforcement stance requires the flexibility to handle economy-specific problems, and should promote a convergence to a broadly agreed set of goals, standards, prohibitions and methods that will provide a transparent regulatory framework and incentives for businesses and consumers to get the most out of market processes, thus enhancing private and social welfare. A harmonised approach would involve each economy taking account of what is happening in its neighbouring economies, and through consensus following a common path on as many issues as

[19] If broad agreement on the joint treatment of airline competition issues could be established by a small number of countries, this could induce other governments to pursue similar policies, if only because domestic firms not used to competitive pressures may find it much harder to compete in regional markets where competition policies have been effective and where buyers are better informed and more demanding that their requirements be met by firms, whether domestic or foreign. Plurilateral agreements are already used in air transport markets, for example in Europe and among groups of APEC members. A plurilateral agreement could emerge from negotiations on air transport market access between Europe and the US (see 'Open skies hits turbulence', *Australian Financial Review*, 14 February 2004, where it is suggested that sticking points are the American position on 49% foreign ownership cap for US airlines, and limits on foreign carriers' access to domestic routes). However, plurilateral structures do not necessarily lead to global free trade, either because their architecture makes intersection difficult or because they create new interests that preclude further extensions to their membership. See Andriamananjara (2002, 2003).

> possible, including policy development, legislation, administration, education, enforcement, penalties and review. The keywords should be communication and convergence . . .

There is some guidance from other multilateral activities. Much debate has occurred in recent years over the need to develop a viable multilateral competition policy to be administered through the WTO, and also to develop best practice guidelines for competition policy and enforcement through agencies like the OECD and the International Competition Network. Europe has shown the way in promoting international competitiveness.[20] It is now up to other regional groups to follow this lead, and for international bodies like the WTO to encourage the development of an international merger policy regime for the airline sector that promotes efficiency and competition.

Piecemeal competition-related provisions have been included in many WTO Agreements, including, for example, in various GATT Articles mainly related to anti-dumping provisions and state-owned enterprises; in GATS (General Agreement on Trade in Services) provisions with respect to monopoly and anti competitive behaviour, as well as domestic regulation; and in the TRIPs (Trade Related Aspects of Intellectual Property Rights) provisions against conduct that unreasonably restrains trade or affects adversely the transfer of technology. As well, Trade Policy Reviews frequently deal with issues related to competition. ICAO has drafted a model clause on competition safeguards which lists examples of conduct that may be anti-competitive in air transport markets. This clause also provides for consultations and for a dispute resolution mechanism with respect to those behaviours.[21] The clause could be combined with other material into a GATS Reference Paper on Air Transport Services, which could include the principles to be applied to domestic regulation as well as detail on desirable levels of international cooperation.

Competition law and enforcement philosophies and practices within economies will always reflect the local underlying political, economic, and legal culture and history of the country. Views will differ on reasons, content, objectives, processes, instruments and timetable.[22] Immediate or full agreement cannot be expected. But a timetable and a commitment to a process of convergence on principles and methods, a harmonising yet flexible process of developing a shared multinational approach, is essential in order to promote efficient airline markets. With such cooperation, experience and capacity can be shared, and the complete intersecting picture and all of its implications can be assessed. Such integration could begin simply with information exchanges and then expand into the more complex process of shared commitments, building policies and infrastructure (including an appeals mechanism), and educating the industry on its new regulatory environment. These gains, however, will not be free of adjustment problems, nor will they be symmetrical in their occurrence. But transition problems should not be used as an excuse for a lengthy delay in getting the system rolling.[23]

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[20] Neelie Kroes (2006), the European Commissioner for Competition Policy, has observed that cross-border mergers, especially in sectors where large national incumbents have been present, tend to be more favourable in terms of competitive outcomes than amalgamations between national players in the same sectors. As Kroes points out, the single market rules of the EU, and Article 21 of the EC Merger Regulation, forbid national governments from using unjustified steps to prevent the consummation of cross-border mergers that have a European dimension (and hence the approval given to the Air France-KLM merger).

[21] See http://www.icao.int/icao/en/atb/atconf5/docs/ATConf5_conclusions_en.pdf (accessed 15 September 2008).

[22] Or, in other words, the economist's Magnificent Seven list of questions: what, who, where, how, how much, for whom, and when.

[23] The Closer Economic Relations Trade Agreement between Australia and New Zealand has shown that harmonisation is possible in the enforcement of competition laws, especially in the context of predatory behaviour. A company with a substantial degree of power within Australia or New Zealand, or both, must not take advantage of that power for one of three proscribed anticompetitive purposes. A misuse of market power in any market in the two countries can be attacked by the competition agency of either economy. See Round et al.

7. Summary and conclusions

Pressures mount for airlines to become more efficient globally and proposals for mergers and alliances are increasing. Different countries will face proposals that will simultaneously affect the competitive process in markets which lie within or overlap their jurisdictions, as well as in markets over which they have no regulatory mandate. When competition regulators act independently and where agreement is required before a merger can go ahead, a country that seeks to reduce the likelihood of approving a socially-damaging merger is more likely to reject merger applications. The deliberations and priors of that country on the trade-off between the two types of regulatory error therefore become dominant. However, while independent assessment may lead to the rejection of mergers or alliances that will enhance global welfare, the cost of that risk may be less than that of building a more complex set of institutions to avoid the problem.

If producer interests have a powerful influence over regulatory agencies (a likely situation in the early stages of the development of any new competition policy), there will be a higher probability that mergers which lower global welfare will be approved, although this outcome will be less likely if the countries and their regulators are at different stages in developing a culture for competition. It is also less likely when regulators are independent of any political influence.

Different countries will display differing attitudes to regulatory decision-making errors and their consequences. A relatively less developed country might approve mergers that will damage the competitive process on a wider scale, on the grounds that the costs of this error will be short-lived (although this is not necessarily the case) and that lowering the risk of making such an error would involve considerable regulatory effort (this is undoubtedly true, but carries with it a much greater and more geographically dispersed long-run social benefit). In contrast, a merger could be rejected under one regime even though on a more global evaluation the transaction could be welfare enhancing.

Developed countries should be heavily involved in programs of capacity building to share their experience on methodologies, errors and outcomes with countries and institutions at earlier stages of development. The goal must be to deepen and shorten the learning period, and to bring together policy procedures and methodology, so that when cooperation or assessment of the same or similar factual situations is required, any differences of opinion will be minimised. Then can we be more confident that socially good airline mergers and alliances will be approved, and socially-damaging ones will be rejected. And, as appealing as this goal might be, it is still a second-best one: first-best would see a single international authority to consider the numerous competition issues that arise in international airline markets.[24]

The horizontal and vertical alliances and mergers in the airline sector to date (whether voluntary or defensive) have been designed to protect the market positions of the participants. It may now be difficult, if not impossible, to unwind these at any geographical level. The situation is not unlike that of regulating a market faced with what are known as creeping acquisitions. Here, no single acquisition that adds incrementally to market share can be assessed as substantially lessening of competition, but a point is reached when the acquirer clearly has amassed significant market power and it is too late to rely on structural remedies –

(2006) for further details of this Agreement.

[24] The situation is complicated by the reality that some airline issues will be strictly of a domestic nature. A way must be found to treat these in a national manner that is strictly consistent with the principles and practice of handling the international issues in a supranational body.

and behavioural remedies are much harder to implement and enforce. This point of no return must be carefully anticipated. Use of trigger mechanisms may help manage the problem, as can carefully developed merger guidelines that are revised through experience and changing market circumstances.

It is desirable that one country, or a group of countries, takes the lead in promoting common policy directions, statutory coverage and language, and also in encouraging regulatory capacity building and cooperation towards a harmonised approach to common issues. However, as Round (2002) has noted, the reality and speed of convergence of competition policies, removing differences in approach, ideology and method, depend on the development of a joint culture for competition and an appreciation of its contribution to efficiency and social welfare. History shows that convergence to common competition policies and enforcement procedures, let alone jurisprudence and precedent, rarely emerges quickly, as different countries' stakeholders respond to, and are driven by, different incentives, endowments, aspirations, and micro- and macro-economic environments. Despite these differences, regulatory authorities will have to interact if they are to come up with sensible answers.[25]

The way to start is to find a champion or two committed to the goal. Research into perceived problems could be undertaken, and detailed assessments could be made of what controls might be desirable, and whether current existing methods and precedents from single countries can be adopted, or whether a new regulatory method is called for. The question should not be whether a converged treatment of airline market competition will happen, but rather when will it occur, how it will occur, based on what model(s), with what efficiency and distributive goals, in what legislative manifestation, and with what agreed enforcement priorities and methods. What is now called for is the establishment of understandings on principles, sequencing, capacity building, methods, enforcement, remedies and review.

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[25] The recently proposed merger consideration protocol between the Australian and New Zealand competition authorities (outlined in footnote 8 above) may, in time, provide a useful model for consideration by other, wider groups of countries.

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