Air Transport Policies and Frequent Flyer Programmes in the European Community - a Scandinavian Perspective

by

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Preface

In 1997, the Research Centre of Bornholm had the pleasure of having Susanne Storm, from the Department of Economics, Odense University, as a guest researcher. Susanne's academic discipline is law, in respect of which, she has a special interest in consumer protection and marketing law, notably in the context of legislation drawn up by the European Union.

During the 1980s, the European Community began taking an interest in the burgeoning of the travel and tourism industry, and what might be required in the form of market regulation, given that the consumer is buying the product *unseen* from a brochure. The culmination of this was the 1990 European Directive on Package Travel. Alongside this development was the liberalization of airline operations, following on from deregulation in the United States. With such a level of activity, it was natural that Susanne's research field would involve her in this subject area. This report is the outcome of a line of enquiry into customer loyalty programmes undertaken by airlines to protect their market share.

Svend Lundtorp
Head of Research
May 1999

Acknowledgements

The initial idea of looking into the problems posed by the increasing popularity of frequent flyer programmes originated in stimulating conversations with Martin Chase SJ of Niels Steensens Kollegium, Copenhagen. Anne-Mette Hjalager of Forskerparken, Aarhus, encouraged me and was helpful in suggesting possible sources for the project. It was made possible to implement the project by the generous leave of absence granted to me by Odense University and the no less generous welcome extended to me by Research Centre Bornholm in Nexø during the spring of 1997. I would like to express my sincere gratitude for this.

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Furthermore, I would like to thank Professor Allan Beaver, guest researcher at Bournemouth University, who kindly read drafts of this paper and made many helpful suggestions. Any remaining errors and infelicities of style are entirely my own.

Bente Hansen of Research Centre Bornholm and Annette Schmidt-Mogensen of Odense University have made the manuscript readable by their untiring efforts to correct it. My research assistant, stud. mag. Bettina Götsche, has provided invaluable help in working with me on several draft versions of the paper. I would like to thank them for all their generous help and assistance.

This paper takes into account development in the market for air transport until the end of 1997. Some later events are referred to, however, as and when the material became available.

Susanne Storm

Auther's Preface

Frequent flyer programmes are loyalty schemes, the object of which is to keep customers loyal to the airline operating them. The central concept of the programmes is to offer free flights to their members based on the number of points or mileage saved up by the members each time they fly with the airline. The programmes were first introduced in the US in the beginning of the 1980s by airlines operating on the deregulated market. They have since spread to the European market which was liberalized and made subject to the competition rules of the EC Treaty in the 1980s and 1990s. At the same time as the European airline companies entered into various alliances to survive under the new conditions in the deregulated market, and as some member states tried to secure the survival of their national airline by various grants of state aid, frequent flyer programmes became an important factor in the fight for airline survival and were recognized as a highly successful marketing tool. They attract high yield business travellers, they enable seats to be filled on flights where they would otherwise be empty and they enable airlines to collect detailed information about their customers and compile it in databases to be used in direct marketing. They are consequently recognized as a powerful marketing tool, so that no airline can afford not to have or not to participate in one. The negative effects which follow from this are obvious: frequent flyer programmes become a barrier to new entrant smaller airlines when they attempt to enter the market as the programmes are costly to run and require a considerable and well-developed route network to be successful. The new entrants and smaller airlines already in operation are forced either to provide higher bonuses than they can really afford or to seek alliance with the established, larger airlines in order to participate in their programme. From the point of view of consumers they obscure the market as it becomes very difficult to calculate what the price of a flight ticket is as a consequence of the complicated and obscure bonus schemes. Another complicating factor is that airlines retain their right to amend the schemes at will, either by making them more generous in order to compete or by limiting their obligations if these are in danger of becoming too onerous. They also have an unethical aspect in that they are aimed at business travellers who fly on business at their employers' expense. Such travellers are able to fly without having regard to the price of the ticket and at the same time accrue the maximum bonus savings for their own private use. This monograph proposes regulation of frequent flyer programmes on the European market by soft laws to make frequent flyer programmes more transparent for consumers and less anticompetitive. It also proposes that bonus savings should be made a taxable benefit of employment. The question remains, however, of whether they are desirable marketing tools at all. It would certainly be desirable to abolish them completely in the long term. This is not at present a viable solution unless it is done on a global basis, since the programmes and their effects have now spread into the global marketplace and airline companies of the Far East are joining forces to establish their own programmes or seeking to enter into alliances with the European and American airline companies. Attitudes to frequent flyer programmes also vary. In the Scandinavian countries a consensus that they are harmful is reached far more easily than in the US for example, where such marketing initiatives are not frowned upon to the same extent, unless they violate the strict American antitrust laws. But perhaps, by initially curtailing them on the European market, the first step towards a final prohibition could be made.

Contents

Introduction

Travel and tourism are becoming steadily more important in the European Community. The European Community is estimated to be the largest travel and tourism region in the world. Even though the mega-market of North America and the European Community will fall just under the world growth average of 48.8 per cent between 1996 and 2006, the third largest region in terms of *travel and tourism employment* is the European Community and North America with 19.8 million and 18.1 million jobs, respectively. The European Community is the largest producer of *travel and tourism gross output* in the world with $1,154 billion expected from 1996. This represents 32.3 per cent of world travel and tourism output. Over the past few decades, as per capita income has risen and families and individuals have gained more holiday and vacation time, travel and tourism have become major elements in the typical household budget worldwide. The largest concentration of *consumer spending* on travel and tourism is centred in the industrialized regions of the European Community, North America and Northeast Asia with $639 billion, $622 billion and $452 billion, respectively, estimated for 1996. *Consumer demand* for travel and tourism services in 1996 is expected to be particularly high in the European Community in which travel and tourism are expected to account for 13.4 per cent of consumer budgets. The European Community is the region with the largest *government funding* for travel and tourism with estimated 1996 expenditures of $120 billion.[1]

Air transport is a vital element in travel and tourism services. The European Community has radically changed the regulation of air transport services in recent years. To start with, the European airlines were national airlines and regulated by bilateral agreements between the European nations. Liberalization began in 1986, when measures adopted by the European Council of Ministers came into operation as the Single European Act was signed and reached its full implementation on the coming into operation of the *third package* on 1 January 1993 and in May 1997. The intention was to allow free-market forces to shape the airline industry. One result of the liberalization process was that European airline companies were able to make use of marketing strategies such as frequent flyer programmes which they copied from the schemes originally developed on the American market for air transport. FFPs became an important factor in the competition between European airlines as each airline attempted to retain particularly their business travellers as its loyal customers.

The aim of this monograph is to examine frequent flyer programmes in the light of general air transport policies in the European Community. In order to do this, the concept of frequent flyer programmes will be examined first (Part I). Then a brief overview of world regulation of air transport in the context of the Chicago Convention of 1944 and deregulation in the United States in 1978 follows. The *open skies* policy and bilateral agreements which are part of the world regulation of air transport will also be referred to in Part II. In addition, a brief study of the policies for air transport from regulation to liberalization in the EC with particular reference to the EC Treaty Article 84(2) about air transport, and Articles 85 - 86 about

1 World Travel & Tourism Council, The 1996/7 WTTC Travel & Tourism Report. Figures from pp. 15, 17, 19-20 and 24.

competition, will be made in Part II. In this context, privatization and state aid regulated by Articles 92-94 of the EC Treaty, as well as airline partnership agreements and Commission control according to Article 85 as well as the Merger Regulation 4064/89 will also be examined.

In Part III the historical development of frequent flyer programmes (FFPs) in the US and the introduction of FFPs by European airlines will be examined. Closely connected with FFPs both in the US and in the European Community are computer reservation systems, which will also be referred to in Part III. Finally, the role of FFPs in the Scandinavian countries will be described in this section. The purpose of the study is to make a case for regulation of frequent flyer programmes and to put forward proposals for such regulation. This will be done in Part IV.

Part I. The frequent flyer programme - concept and problem [2]

A. Discounts and price reductions

Many forms of discounts can be used by travellers regardless of whether they travel frequently or not. These forms of discounts do no require an advance commitment from travellers. In the area of air transport, this is the case for APEX and excursion fares.

For persons who are frequent travellers by bus, train or air, the many forms of discounts or price reductions all have one thing in common: the customer must make some kind of investment in advance in order to obtain the discount. Three main forms of such discounts can be distinguished. 1) A price reduction is given to customers who travel often by train or bus. The customers are required to invest in a travel pass for a certain number of journeys. They have to pay in advance for all the journeys, and the total price of all the journeys is then reduced. The discount is fixed as a percentage of the total price, which is easy for the customers to assess. 2) A price reduction can also be connected with a travel identity card. In these cases, the customers must first invest a certain sum of money when they acquire the card, but after that, the possession of the card entitles them to a price reduction every time they travel. The customers must travel a certain number of times to recover the cost of the card, after which the price reduction takes effect. The amount of the reduction is cumulative, i.e. the more the customers travel, the higher their reduction will be. 3) A season ticket allows the bus or train travellers to travel as often as they want within the period for which they have bought the season ticket. Also in these cases there is an initial investment in the season ticket, but the price reduction is easy to calculate as long as the travellers keep an account of all their journeys. This enables them to compare the price of the season ticket and the full price of all the journeys they have made.

None of these forms of long term price reductions are popular to any marked extent in the airline industry. They are not very likely to attract customers, as the initial investment which the traveller would have to make is considerable. However, SAS is introducing both the concept of the travel pass described under and the season ticket described in, to begin with on the routes Copenhagen-Oslo and Copenhagen-Stockholm.[3] This new initiative is advertised so that it links the possession of an SAS travel card or season ticket with membership of EuroBonus, SAS' frequent flyer programme: customers obtain extra bonus points when using them. The advertisement of this new initiative is directed towards the business traveller: one

2 Part I is based on the marketing material, advertisements and membership guides for frequent flyer programmes published by the airlines. As most of the major airlines in the world have FFPs, and this study cannot possibly cover them all, the FFPs of the following airlines were selected: SAS, British Airways, Lufthansa, Air France, United Airlines and Virgin Atlantic. The membership guides are only available to members, so one must become a member of the programme in question in order to obtain the guide. A new member gets his/her first real insight into how the programme works only when he/she starts flying with the airline and receives his/her first bonus statements. This chapter also draws on recently published articles in the Danish daily newspapers.

3 Advertisement in the Danish daily newspapers, Easter 1997.

advertisement depicts a businessman who is told not to be envious if his colleague is given a travel card, not even if the colleague takes his wife on a trip to London for the bonus points thus obtained. From the middle of May 1997, similar travel passes and season tickets will be introduced on flights between Scandinavia and Amsterdam, Brussels, London and Helsinki.[4] The Danish airline Maersk Air, which operates domestic flights in Denmark and international flights to Amsterdam, Frankfurt, Brussels, London, Paris, Stockholm and Oslo, both from Copenhagen and the provincial airport Billund in Jutland, marketed a bonus system called BusinessBonus for the use of firms and employers only - not for private travellers. It is very similar to the travel pass arrangement (1). As mentioned, only firms or employers can become members, and all the firms' employees accumulate bonuses when they travel for the firm with Maersk Air. The bonus trip belongs to the firm and can be used for business purposes. It is thus a matter for the employer to decide who is to have the free bonus trip. Maersk Air's bonus system is simple: for every ten return flights to one of the airline's European destinations, the eleventh is free and may be taken to any of these destinations.[5]

B. The frequent flyer programme - concept

The frequent flyer programme (FFP) is a totally different concept. Whereas the discount schemes mentioned above have as their aim to give a price reduction to customers who travel often over a long period, this is not the primary aim of the more sophisticated FFP programme. The FFP functions rather as a marketing strategy, introduced by the airlines for the purpose of keeping their customers loyal and thus preventing them from flying with any other airline, even though a competing airline, particularly a new entrant on the market, may be able to offer a better bargain or a more convenient flight. FFPs are designed to ensure customer loyalty by offering various forms of bonuses or *perks* to customers for which the customers save up each time they fly. The more often they fly with the airline, the more points or air miles they will accumulate.[6] At the core of these programmes there is thus the accumulation of points or air miles which must be redeemed at some future point in time. The accumulation of points takes place when the member flies, but in their more sophisticated forms members may also accrue points when going to a restaurant or using their credit card, renting a car, telephoning long distance or staying in a hotel, as airlines will often have partnership agreements to this effect with other businesses. When the member has saved up the required number of points, these can be redeemed by the traveller, who obtains a free flight, or an upgrade from one class to a

4 Article in the Danish daily newspaper *Jyllands-Posten* on 23 April 1997.

5 Perhaps Maersk Air's programme is an example of the simple FFP which permits its members to earn a free ticket after completing a predetermined number of flights. This type of programme will often be a typical start-up programme launched before the development of a more advanced FFP. The future will show whether Maersk Air uses it this way. In fact, Maersk Air has later entered into an alliance with SAS and abolished its programme. The airline now participates in SAS' EuroBonus.

6 Under the US programmes the number of bonus miles accrued depend on the distance flown as well as the class of travel, while the scheme operated by British Airways distinguishes between two criteria: class of travel and whether the journey is within the UK, within Europe or elsewhere. Extra points are earned if the passenger is a member of one of British Airways' clubs. Most of the European schemes have adopted the American system.

higher class on the plane, or a free baggage allowance.[7] The traveller may also choose a free overnight stay in a hotel, free car rental, luxury goods, cruises or other holidays, or a special activity, such as a three-day golf passport to an attractive golf course. It is characteristic of all FFPs that the customer's savings and the bonus are made up in points or air miles, never in cash. Indeed the membership terms and conditions contain a special clause according to which membership points or mileage cannot be converted into cash.[8] Members who accumulate many points are often given higher tier or level memberships, normally called gold and silver memberships or other attractive names. These higher level memberships entitle the customers to certain advantages every time they fly, such as express check-in, access to a special lounge in the airport, top priority booking and waiting list priority, registration of the member's seating and meal preferences, a limousine service to and from the airport, etc.

However, it is part of the FFP concept that the airlines retain strict control over the content of the programmes. Most airlines have thus introduced limitations in their programmes of which they can make use when it suits them. The following limitations are five typical examples to be found in most of the programmes: 1) a threshold is fixed before a member can start to redeem points;[9] 2) saved up points are valid for redemption only for a limited period of time, so that they must be redeemed before this time limit expires;[10] 3) there is a limitation of the period of membership which entails that a member who accumulates no points during this period risks having his/her membership cancelled;[11] 4) the airline has blackout periods, i.e. busy or peak periods during which saved-up points or mileage cannot be redeemed as determined by the airline itself;[12] 5) the airline retains its right to terminate the programme with or without notice and to cancel accumulated points.[13] These are just five typical examples taken from the membership guides to illustrate te fact that all the airlines reserve their right to modify their

7 Some FFPs offer two kinds of awards: the better award has no limitations (e.g. no blackout periods), but the member is required to save up more points or mileage in order to redeem it. The other award is available at a lower number of points or mileage, so it is easier to save up for it, but there are blackout periods and other restrictions. United Airlines and Air France offer two such kinds of awards.

8 Thus the membership guides of SAS, British Airways, Lufthansa, Air France and Virgin Atlantic.

9 SAS has a threshold of 20,000 points for Swedish members, 12,000 for Norwegian members and 10,000 for Danish members.

10 SAS has a four-year period, so that points earned in 1996 must be redeemed at the latest on 31 December 2000. British Airways has a five-year period; Lufthansa, Air France, Virgin Atlantic and United Airlines all have a three-year period.

11 SAS reserves its right to cancel a membership, if a member earns no points during a continuous period of 24 months. British Airways indicates the term of membership on the card and also has an initial two-year membership period. Lufthansa and Air France both have a period of 36 months. Virgin Atlantic has a two-year initial membership period which is renewed only if the member has accumulated points. United Airlines has an initial 12-month period, and after that members who fail to earn mileage during the subsequent three years either have their membership terminated or they lose all accrued mileage.

12 United Airlines has a separate folder with blackout dates for the years 1997-98 covering both the airline and its partners.

13 SAS reserves its right to terminate the EuroBonus programme with three months' notice and to cancel saved-up points after the expiry of that time limit. Air France has a similar provision. Virgin Atlantic reserves its right to cancel the programme with six months' prior notice and after the expiry of this period credits can no longer be redeemed for awards. British Airways, Lufthansa and United Airlines may terminate their programmes with immediate effect and without giving notice. Lufthansa establishes a kind of passive acceptance in case of amendments, as the member is regarded as having approved these, if he/she does not protest within a month but continues to use his/her card.

programme rules completely at their own discretion. Other examples are that the airlines may, whenever they see fit, exclude discount fares, raise the levels of required point savings and change the redemption rates.[14]

The recurring elements of the FFPs may be summed up as follows. They are not related to a cash value. They are structured so that the value of the savings increases as the points or mileages accumulate, thus making it less attractive for a member to accumulate savings in more than one FFP. The member must accumulate savings sufficiently quickly to earn an award, before the savings expire. Unredeemed points may not be permitted to accumulate in such substantial quantities that the airline would get into financial difficulties if all its FFP members rushed to redeem their points at the same time. The airline is at liberty to adjust savings on a particular route, if this provides the airline with an advantage over a new competitor on the same route.

Only individuals - not firms, businesses or other legal entities - can become members of FFPs. This is clearly stated in all the membership guides.[15] A very important aspect of the FFP concept is that the programme is aimed - indirectly - at the business traveller. Customers who fly for their own private purposes are usually not frequent flyers, and thus it is of no benefit to them to become members of an FFP. If they fly for holiday purposes, they will either fly individually but as cheaply as possible, i.e. on economy class at a reduced fare - such as APEX and excursion fare - in which case they will accumulate fewer points or none at all, or they will choose a package holiday. Business travellers, on the other hand, do fly often and often on first or business class where the highest point savings are to be made. They do not themselves pay for their ticket, their employers do, as they travel for business purposes. As membership of an FFP is personal, the business traveller accumulates bonus points or mileage on flights undertaken on behalf of his employer and paid for by him/her. The membership guides all state that points or mileages are awarded to members personally regardless of who paid for the ticket. The point or mileage savings can thus be redeemed only by the employees themselves and for the purposes of their own private travel. This means that the businessman or businesswoman is not encouraged to book the cheapest flight but rather to book the flight which will give him/her most bonus points, since the employer must pay for the ticket in any

14 British Airways, for example, reserves its right not only to raise the mileage levels required to attain a particular award, but also to add an unlimited number of blackout days and to limit the number of seats available to some destinations. Virgin Atlantic reserves its right to prohibit reward redemption on certain dates of the year and in certain places to limit the number of rewards available at any time, and to place other restrictions on rewards. United Airlines states this indirectly by saying that a premium award, which requires more mileage than a saver award, is unrestricted, and the member who holds it can travel any time a seat is available on the requested flight.

15 An exception is the above Maersk Air bonus programme - BusinessBonus - of which only firms or businesses can become members. China Airlines has introduced an innovation in this area with its marketing of a corporate membership programme - *Corporate Bonus Mileage Programme*. The airline states in its promotion brochure: *Now companies can finally receive awards from their staff travel accounts* (quoted from Rowe, Irene Vlitos, *International business travel - a changing profile*, EIU research report 1994, p. 184. The Abbreviation EIU stands for *the Economist Intelligence Unit*).

case.[16] Furthermore, points can be redeemed not only for his/her own benefit but also for the benefit of any other person who accompanies him/her on the bonus flight. His/her spouse and children under a certain age may also redeem his/her points and even travel independently of him/her. Thus in a recent advertisement for SAS EuroBonus, a rather worried looking father, namely the businessman, is depicted holding his small child, because his wife has redeemed his points and has flown off on holiday.[17] The 1996 English edition of SAS's terms and conditions - for members outside the Nordic countries - makes it the responsibility of its members to inform their employer in advance when they plan to earn points on flights, hotel stays or car rentals paid for by the employer. It is also stated that points earned for business travel may not be used for private purposes without the consent of the employer, and that government officials in some countries may be barred by regulation from using points saved up on business travel.[18]

In this context, the question of taxation of free bonus travel arises. In Denmark free bonus travel for points accumulated while travelling on business is liable to be taxed. It is a duty of persons who have accumulated bonus points when travelling on business, and who use their bonus savings for private travel, to inform the tax authorities when they submit their annual tax report.[19] Free bonus travels for holiday purposes which has been paid for by the business traveller's firm has now caught the attention of the Danish tax authorities. The Union of Tax Administration Officials is planning to put pressure on the minister for taxation to make it a duty of SAS to report bonus travellers to the tax authorities.[20] SAS is opposed to the introduction of such a duty, maintaining that it would give other airlines an unfair competitive advantage unless the same duty is imposed on those other airlines operating in Denmark. The taxation rules in Sweden have been amended as from 1 January 1997, so that it is now a duty of the employee to report to his/her employer when redeeming bonus points for private travel,

16 According to an article published in *Jyllands-Posten* on 21 April 1997, a number of travel agencies confirm that business travellers choose a particular airline in order to save up bonus points when they book a business flight, rather than another airline with a cheaper option. They also choose to travel business class rather than economy class, they accept long waiting hours and a connecting flight in order to fly with the chosen airline rather than a direct flight with another airline. They may even travel unnecessarily. The travel agencies also confirm that even if they have worked out a cheap and economical option, this may be rejected by the traveller because he/she wants to save up points. In such cases, the travel agency will insert a notice in the invoice to the employer to the effect that a cheaper option than the one chosen was available, which normally leads to the booking being altered.

17 SAS advertisement in *Politiken* on 23 April 1997.

18 The SAS 1996 Swedish edition has an identical clause, but there is no similar clause in the Danish 1996 edition. The Norwegian edition omits the requirement that points may only be redeemed for private travel with the employer's consent, but is otherwise identical. The membership guides of British Airways, Lufthansa, United Airlines and Virgin Atlantic contain no similar clauses concerning business travel and bonus savings. The Air France membership guide states that each member is *responsible for informing any third party or legal entity paying for the tickets or services credited regarding the miles and advantages obtained with the programme*.

19 SAS' 1995 Danish edition of terms and conditions stated that members of EuroBonus are themselves responsible for keeping within the rules of the taxation legislation in force. This clause is not repeated in any of the 96 editions of the terms and conditions.

20 Articles published in *Jyllands-Posten* on 23 April 1997 and in *Politiken* on 24 April 1997.

if the firm has paid for the travel which enabled him/her to accumulate the points. It is then a duty of the employer to report this to the tax authorities.[21]

That FFPs are marketing tools designed for the purposes of keeping customers loyal, and not a discount scheme aimed at giving frequent travellers a price reduction, is made clear by two related factors. First, the discount schemes referred to at the beginning of this chapter give very clear information about the amount of the participating traveller's savings, normally by indicating the traveller's savings as a percentage of the total price. The FFP, on the other hand, is constructed in such a way as to make it practically impossible to estimate the amount of savings involved, basically because the savings are not linked to any actual cash value but to a symbolic value such as points, mileage or credits. Second, all the FFPs distinguish between the class flown. Members may earn points on economy class, but usually the amount is doubled or trebled if the member flies business or first class. Some programmes do not award points, if the member flies economy class or on a discounted fare. In other programmes, the members must first fly business class before they can earn points on economy class, or they may be required to fly economy class several times within a short period of time before they can start earning points on economy class.[22] The information in the membership guides about earning credit on first or business class is usually good, but it is often insufficient even to the point of obscurity where savings on economy class or on a reduced fare are concerned.[23]

C. Frequent flyer programmes - the problems

In the following, the criticisms - summarized in eight questions - levelled at frequent flyer programmes by academics will be listed and some comments made about each. The intention here is merely to enumerate these criticisms, not to evaluate them.

The *first* question is also the most obvious: do they work? Most academics agree that a frequent flyer programme is a very efficient means for an airline to use in order to retain its hold on customers. This assumption is confirmed by the figures. In 1993, 30 million US residents were members of FFPs. That is 11.5 per cent of the entire US population. Compared with the US membership, figures in Europe are less impressive. However, 86 per cent of European business travellers belong to an FFP, even though their loyalty may be only a

21 *Ibid.* The British Airways, Air France and Virgin Atlantic terms and conditions contain a clause according to which members are solely responsible for any tax liability which they may incur as a result of participation in the FFP or of the earning, use or redemption of any awards or mileage. United Airlines' and Lufthansa's terms and conditions do not refer to this question.

22 Thus Virgin Atlantic. Members are required to take one qualifying flight in its Upper Class or three qualifying Economy round trips within a twelve month period. After the third Economy round trip, the member is credited with the actual miles flown for that flight and previous flights. Once the member has qualified, he/she earns one mile for every mile flown in Economy Class for all subsequent flights.

23 To give but one example: it is stated in the British Airways' FFP terms and conditions that members can earn mileage on certain discounted fares, the eligible booking classes being R;F;D;J;S;B;K;M;L. A member booking an economy class ticket will then notice on the quarterly statement that no mileage is credited, because the booking class was V. This is an example of a very low level of information. The other FFPs are similarly obscure, except possibly that of SAS which always awards points for economy class travel, regardless of the fare booked. The number of points awarded is stated very clearly in the SAS membership guide.

polygamous loyalty.[24] Referring to polygamous loyalty, Mark Uncles mentions that this kind of loyalty is typical of business travellers:

> *… Official airline reports show that, on average, Britain's busiest business travellers are loyal to three different FFPs... Those who travel abroad once or twice a year might patronize solely British Airways and stay exclusively at Holiday Inn, but their loyalty reflects only light buying. It reflects the fact that their opportunity to fly with different airlines and stay at different hotel chains is very restricted. In contrast, the busy business traveller will tend to use several airlines, several hotel chains, and join multiple loyalty schemes.*[25]

The *second* question is: how does the existence of FFPs affect consumer choice? Do frequent flyer programmes influence consumer choice in a reprehensible way, distorting consumers' viewpoint away from a sober consideration of price, quality and safety to a decision-making focussed almost entirely on saving up points or mileage? Ian Verchère makes the following comment on consumer choice and FFPs:

> *According to an investigation by the US General Accounting Office (GAO), [a research agency of the US Congress into public policy issues] into airline operating and marketing practices, 81% of 520 travel agents polled said that their business customers choose flights to accumulate additional frequent flyer miles in more than half the flight decisions they make... The GAO found that: "almost as many agents believe that the ease of building up miles on a single airline is a major factor in passengers' decisions about which FFP to use.*[26]

One survey has suggested that regular travellers change 10 per cent of their itineraries to benefit from particular FFPs.[27] Passengers are known to refuse a cheaper fare in favour of an alternative carrier offering a higher accumulation of frequent flyer mileage. The expiry limit for using accrued mileage also encourages passengers to travel on an airline as often as possible in order to earn an award before the expiry deadline.[28] B. K. Humphries makes this comment: *Frequent flyer programmes are by no means as popular with employers. It has been estimated that overpayment for and overuse of airline services as a result of such programmes amounted to over USD 4 billion as early as the mid-1980s, equivalent to almost 10 per cent of total US airline revenues at that time*[29]

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24 Figures from an unpublished paper, *Frequent Flyer Programmes Competition Aspects*, by Durande, M., an official of DG IV of the European Commission, 1996, p. 1.

25 Uncles, Mark, The seven perils of loyalty programmes in *The Marketing Society Review*, Autumn 1994, pp. 18 and 19.

26 Verchère, Ian, Frequent Flyer Programmes in *EIU Travel & Tourism Analyst*, No. 3, 1993, p. 8.

27 Mason, Gary and Nick Barker, Buy now fly later: an investigation of airline frequent flyer programmes in *Tourism Management*, Vol. 17, No. 3, 1996, p. 221.

28 In April 1997, articles were published in the Danish newspaper *Jyllands-Posten* according to which Danish travel organizers and the Danish Association of Travel Managers maintain that business travellers choose an airline according to the amount of bonus points they will save up, rather than one which offers a cheaper and more convenient flight.

29 Humphries, B.K., Are FFPs anticompetitive? in *The Avmark Economist*, July/August 1991, p. 12.

The *third* question is: do FFPs obscure prices so that consumers are unable to find out what they are really paying for the ticket? It was mentioned above in section B that it is a characteristic of all FFPs that the customer's savings and the bonus are made up in points or air miles, never in cash. As the bonus points are unrelated to any cash value, it is practically impossible for the consumers to estimate the value of their point or mileage savings and consequently also the price of the ticket. That this is the case is illustrated in the following table of carriers' point values.[30]

Carriers' Point Values					
1	2	3	4	5	6
FFP	Points Earned On One-Way Trip	Price Per Flight (DKK) *	No. of One-Way Trips Needed For Free Flight **	Total Needed Payment Per Free Flight ***	Price Per Point (DKK) ****
British Airways Executive Club	1175	1.715	27.23	46.706	1.459
Frequence Plus	1000	1.765	40.00	70.600	1.765
Miles and More	2000	2.210	25.00	55.250	1.105
EuroBonus	1200	3.335	25.00	83.375	2.779
Finnair Plus	3648	4.980	19.19	95.559	1.365
Icelandair FFP or Vildarkort	n.a.	n.a.	n.a.	n.a.	n.a.

n.a. = not available.
* Prices as of 29 May 1997.
** Total amount of points needed for free return flights/amount earned per one-way flight.
*** Column 4 entry x price per flight.
**** Column 5 entry divided by needed amount of points for free return ticket.

The *fourth* question is: do frequent flyer programmes segregate customers into two classes, members and non-members, and are the non-members treated as second-rate? FFPs are generally regarded as a great loyalty tool. They allow the company offering the programme to treat customers differently according to whether they are loyal to the company or shop around. Those passengers who travel often, namely business travellers, are the high-yield customers and every airline desires their loyalty. The standard of service afforded other customers is lowered. This development becomes more marked as airports become more congested. The amount of queueing which has to be done by passengers flying economy class is increasing. The public lounges of the European airports are noisy and unpleasant. Business class passengers who are also members of an FFP get wafted through all these procedures and have special lounges. Economy class flyers may not initially feel all that aggrieved, but once they realize that they are being treated differently, conflicts will arise: club members secure benefits, while non-members increasingly feel cheated. Clubs exclude as much as they include. Terrence J. Kearney describes the effect of club membership on non-members as follows:

30 Table compiled by Majbrit Jensen, Lars Kragh Hansen and Thomas Lundegaard, Odense University, May 1997.

While a large proportion of passengers are members of mileage programs, many are not. Some of these nonmembers are bound to realize that they are paying for the awards and the administration of frequernt flyer programs through higher fares and inconvenience.[31]

The *fifth* question is: are FFPs a marketing device which, once one airline has introduced a frequent flyer programme, obliges all the other airlines to establish one themselves at a high cost, even though they would really rather not have an FFP? It is generally assumed that the management costs of running FFP schemes are high: promotional items, investment in building and maintaining databases, the expense of answering hundreds of enquiries. When FFPs are no longer innovations but something that every airline either has or participates in, the overall marketing advantage for the airline will disappear. The only effect is to increase airline costs. Thus the industry as a whole and the majority of passengers would be better off if FFPs were prohibited in some way.[32]

The *sixth* question is: is there a risk that the amount of free travel owed to programme members will become a liability for the airline in question, particularly if the redemption rate suddenly increases? Allan Beaver makes the following comment:

Only half of European business travellers have actually redeemed their awards, although 97% state that they intend to do so at some time in the future. In 1993, there were estimated to be 36 billion unused air travel miles; 600 000 fully laden jumbo jets would be needed if everyone was allowed to travel on the same day! By 1995 this estimate had been revised to 1.4 trillion unused miles worldwide and 620 000 747s; only 28% of the mileage points accrued are redeemed.[33]

To prevent a sudden increase in redemption demands, most frequent flyer programmes incorporate limitations as described above in section B. The airlines may for example insist on redemption within a given period of time, two or three years, and on retaining their right to withdraw their schemes on giving notice. Another aspect of this question is that passengers may end up occupying too many seats which could be going to fare paying passengers. This risk is increasing as the FFPs of carriers *mature*.[34] The airlines seek to avoid this risk by raising FFP levels and by introducing blackout periods.

The *seventh* question is: do frequent flyer programmes enable the big, established airlines to keep out of the market smaller, new entrant airlines which are not able to offer equally attractive FFPs, both because of the cost and because of the smaller route network they are

31 Kearney, Terrence J., Frequent Flyer Programs: A Failure in Competitive Strategy, with Lessons for Management in *The Journal of Consumer Marketing*, Vol. 7, No. 1, Winter 1990, p. 38.

32 FFPs are considered from this point of view by Beaver, Allan, in his article Frequent Flyer Programmes: the beginning of the end? in *Tourism Economics*, 1996, Vol. 2, No. 1, and Humphries, B.K., *op. cit.*

33 Beaver, Allan, *op. cit.*, p. 46.

34 Beaver, Allan gives an example on p. 47 of his article.

able to command? It is generally agreed that FFPs have perceived anticompetitive effects as they enable the established airlines to protect their market positions and curtail the threat of new entrants. For a new entrant operating on a smaller scale than the established airline on any route, the FFP of the established airline becomes a major obstacle rather than a mere marketing detail.[35]

The *eighth* question is: do FFPs contain elements which from a purely ethical point of view appear unacceptable? Are business travellers encouraged to save up points for personal use on flights paid for by the employer? It is difficult to defend as efficient those practices which reward undisclosed distortion of choices by employees at the expense of employers. There is an increasing concern in companies which pay for their executives to travel that these companies neither get the benefit from these programmes, nor can they decide which flights their executives are to take when travelling on business. Some executives may take flights which costs more just to get the mileage points. This aspect of frequent flyer programmes is commented upon by Allan Beaver as follows:

> *…; companies have felt that the benefits of Frequent Flyer Programmes belong to them, rather than to the individual employees and some airlines are reacting to the pressure. In the USA, organizations such as the Frequent Flyer Service are managing the benefits on behalf of the companies, instead of the employees who earned the benefits while on company business. It can only be a matter of time before similar companies are established in Europe. Air France now quotes special corporate rates; air tickets issued at those rates do not then qualify for FFP mileage points... Virgin is the first UK airline to respond to this pressure, by granting frequent flyer points to companies as well as to individual travellers... There is an enormous amount of pressure from certain businesses for the freebies and bonuses to go to the people who pay and not to the people who travel. In most cases, however, firms still tend to regard the benefits as compensation for employees having to spend periods away from their home.*[36]

To attempt an answer to these questions, the whole issue of the regulation of air transport and competition, in the context of which FFPs must be seen, is examined in Part II. In Part III, the historical development of FFPs is considered in the US, in the European Community and in the Nordic countries. Suggestions for regulation of FFPs are put forward in Part IV.

35 Comments made by Verchère, Ian, *op. cit.* 1993, p. 10 and Humphries, B.K., *op. cit.*, p. 13.

36 Beaver, Allan, *op. cit.*, pp. 47 and 48. Danish examples of companies complaining over the costs and administrative difficulties which the administration of the bonus savings of their employees caused were quoted in the newspaper *Jyllands-Posten* on 21 April 1997.

Part II. The international and EC legal framework governing the market for air transport

In this section first, the basic aspects of the legal framework of the airline industry in the world and the first attempts to deregulate it, which were made in the US, are described (Chapter 1). Deregulation in the US and liberalization in the EC were intended to free the airline companies from tight governmental control and enable them to compete on the open market. This introduced another danger: no longer subject to government control, the airline companies themselves sought to restrict and distort competition by entering into various agreements. Thus, as a parallel to the liberalization process in the EC, the competition rules in the EC Treaty's Articles 85 and 86, which prohibit anticompetitive behaviour between businesses, were made applicable to air transport, something they had not been from the first beginnings of the Community (Chapter 2). Another trend can be identified which ran parallel with liberalization and the application of competition rules, namely the trend towards privatization of the bigger European airline companies. At the same time, national governments tried their best to continue to protect their national airlines by granting them state aid. The European Commission has controlled the grant of state aid to airline companies under Article 92 of the Treaty (Chapter 3). A third trend at this time was that practically all the European airline companies entered into various kinds of partnership agreements. This development was supervised by the European Commission either under Article 85 of the Treaty or under the Merger Control Regulation (Chapter 4).

1. World regulation of air transport - with particular reference to deregulation in the US

A. The Chicago Convention 1944

The air transport industry has been highly regulated throughout the whole of its history, not only as concerns technical and operational standards in the interest of safety; but the economic and commercial aspects of airline operations have also been subject to a high degree of governmental control. The international regulatory system has developed in the years since World War II, starting from the principles which were negotiated and agreed at the Chicago Convention on Civil Aviation in 1944 by 52 nations.[37] The Convention had two outcomes: first, the founding of the International Civil Aviation Organisation (ICAO), now a specialized agency of the United Nations, which is involved in air transport security, operational and safety requirements and technical regulation; second the establishment of the four basic *principles* of international aviation regulation, namely the principle of *sovereignty*, which means that each state has complete and exclusive sovereignty over the air space above its territory; the principle of *equal opportunities*, which means the equal legal rights of all states to participate in air traffic; the principle of *non-discrimination* according to which international aviation regulation must be made without distinction as to nationality; the principle of *freedom to designate*, according to which each state has complete freedom to designate the national airlines which will operate its air services. Closely linked to the four principles were the *five freedoms of the air*, which contain the following elements: 1) the right of an airline company of one state to fly over the territory of another state; 2) the right of an airline company of one state to land on the territory of another state for non-commercial reasons; 3) the right of an airline company to carry passengers, mail and goods from its own state to another state; 4) the right of an airline company of one state to embark passengers, mail and goods in another state and carry them to its own state; 5) the fifth freedom, which is related to commercial transport between two states other than the airline company's own country. Under this freedom the airline of country A may pick up passengers in country B and off-load them in country C. Closely connected with the fifth freedom is *cabotage*, which is the right of an airline company of one country to embark passengers, mail and goods in another country and carry them to another point in the same country for a fee or a leasing contract. Cabotage introduces competition between domestic and international carriers and is as important as the fifth freedom in the whole issue of air transport liberalization. In the Chicago Convention, cabotage was referred to in the declaration according to which each contracting state may reserve to its own aircraft the exclusive right to carry traffic between two points in its own territory.[38]

The first two *freedoms*, neither of which involve commercial rights to carry traffic, were incorporated in the International Air Services Transit Agreement, also adopted at Chicago. This was subsequently ratified by 95 states and thus has very wide application in international

37 Convention on International Civil Aviation of 7 December 1944, referred to as the Chicago Convention. The Convention came into operation on 4 April 1947.

38 The five freedoms of the air and cabotage are described in more detail in: Vellas, Francois and Lionel Bécherel, *International Tourism*, Macmillan, London, 1995, pp.138-140.

aviation regulation. As for the remaining three freedoms, thanks to the uncompromising positions of the United States, which took a very liberal view, and the United Kingdom, which followed a protectionist approach, the Chicago Conference failed to reach an agreement on the multilateral exchange of commercial rights to operate air services. Thus, the exchange of traffic rights as incorporated in the other three freedoms became an issue to be dealt with on a bilateral basis between states. Two years after the Chicago Conference, the Bermuda Agreement was reached between the United States and the United Kingdom. It became the standard model for bilateral air service agreements between other countries.[39] The tendency of many countries since the Bermuda agreement of 1946 was to opt for bilateral agreements which were highly restrictive, ensuring that a percentage of total traffic on a route was guaranteed for the national carrier of the countries concerned and the number of flights on particular routes limited, allowing only the national carrier to operate.[40]

The general policy of most bilateral agreements was that fares and rates on routes between two countries should be subject to the approval of the two governments concerned. Since the Bermuda agreement in 1946, governments agreed to delegate rate-making to the airlines through the traffic conferences of the International Air Transport Association (IATA), a trade body comprising some 80 per cent of the world's airlines operating on international routes, which cooperates with the ICAO and other international bodies. As a general rule tariffs were set at IATA conferences and then approved by national governments.[41] In 1979, the IATA regulations were changed and member airlines were no longer required to participate in nor to adopt tariffs agreed by the IATA conferences. Because of the non-binding tariff setting process within IATA, the participation of European airline companies was consistent with EC competition law.[42]

The bilateral regulatory system and the nationally based airline industry fostered by the system have been undergoing a profound change because of the policy of reduced government involvement in the commercial affairs of businesses in many parts of the world. This policy became widely accepted in the 1980s and continues to have a powerful influence in the 1990s. It affects many industries such as banking, insurance and surface transport as well as air transport.[43]

B. Deregulation in the United States 1978

Deregulation of the airline industry first appeared in the United States at the end of the 1970s. The US Airline Deregulation Act of 1978, which came into operation on 1 January 1979, and

39 Ebke, Werner F. and Georg W. Wenglorz, Liberalizing Scheduled Air Transport Within the European Community: From the First Phase to the Second and Beyond in *Denver Journal of International Law and Policy*, Vol. 19, No. 3, 1991, p. 496.

40 Holloway, J. Christopher, *The Business of Tourism*, Longman, Harlow, 1994, pp. 76-77. Balfour, John, The Second EEC Air Transport Package - Substance or Packaging in *European Business Law Review*, November 1990, p. 66.

41 Corke, Jim, *Tourism Law*, ELM Publications, Cambridgeshire, 1993, p. 164.

42 Ebke, W. and G. Wenglorz, *op. cit.*, p. 499.

43 World Tourism Organization, *Aviation and Tourism Policies - Balancing the Benefits*, Routledge, London, 1994, p. 28.

which involved the deregulation of *domestic* air services in the US, was the first major step in this direction. The Act gradually abolished the Civil Aeronautics Board, set up in 1938, over a period of five years. Under the Act, control over domestic route allocation and fares was relinquished.[44] Furthermore, in the *international* field the adoption of the *open skies* policy by the US Department of Transportation, which took over from the Civil Aeronautics Board on 1 January 1985, meant that more liberal bilateral agreements on the international aviation market could now be negotiated between the US and other countries. This policy was concerned principally with the establishment of links between US airline companies and European partners. The policy involved among other issues that airlines were to have free access to all routes without restrictions on capacity and frequency. Airline companies were allowed to establish *hubs*, i.e. bases which could be used by each company to group and distribute its traffic to other destinations in its network. Hubs have now been established by the main US airline companies for domestic as well as international routes leaving the US, notably in Dallas, Atlanta, Chicago, New York, Miami and Los Angeles. Companies were also allowed to fix their own tariffs, although *dumping* was prohibited to guarantee the long-term interests of the consumer. Companies in the US and in Europe were enabled to enter into agreements on *code-sharing*, i.e. joint management of routes, for the purposes of reorganization and joint management of their networks in partnership. Commercial agreements concerning air transport operation other than code-sharing were considered not to infringe US antitrust laws. Finally, airline companies were enabled to operate their own *ground services* abroad and allowed non-discriminatory access and use of computer reservation systems.[45]

Up until 1994, only the Netherlands had accepted the United States' open skies policy. The open skies agreement between the USA and the Netherlands enabled KLM and NorthWest to establish a code-sharing system which doubled the number of connecting flights they could offer and won for the two companies a good position in the computer reservation network. Code-sharing agreements outside the open skies policy exist, but they are limited to sharing routes and do not involve streamlining and joint management of the partners' networks. Examples of such agreements are the Lufthansa-United Airlines agreement and the British Airways-USAir agreement.[46]

In 1994, the US government approached seven member states in the EC (Germany, Denmark, Austria, Finland, Luxembourg, Sweden and Belgium) with draft bilateral open skies agreements in the field of air transport. The member of the European Commission who became responsible for transport from 7 January 1995, Neil Kinnock, requested in the strongest terms that none of these member states negotiate, sign or initial any such bilateral open skies agreements with the US, arguing that the Commission was, legally speaking, competent to negotiate these agreements.[47] However, the member states did conclude such agreements with

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44 The consequences of deregulation in the US for international air transport and the adoption of the *open skies policy* is described above in Part II, chapter 1 B.

45 Vellas, Francois and Lionel Bécherel describe this in more detail: see *op. cit.*, pp. 140-141.

46 *Ibid*., p. 142.

47 Accepting such draft bilateral agreements would severely compromise the third package of liberalization measures which took effect on 1 January 1993 and would allow US carriers to operate without restriction to, from and within a substantial part of the EC's internal market, whereas the proposed bilateral agreements did not open up intra-US routes to foreign operators (Commission MEMO/95/24, 2 March 1995).

the US which the Commission had argued were in breach of Community aviation rules. Also in 1995, the United Kingdom concluded a new agreement with the US. The Commission, accordingly, started infringement proceedings against the eight member states in 1995/1996 (the letters of formal notice). On 26 April 1995, the Commission approved a proposal mandating it to open negotiations with the US in this field and it was to be submitted to the Council of Transport Ministers in June of that year. According to the proposal, the Commission was *to* negotiate full market access for Community air carriers for traffic in the US and the Community aviation markets, *to* establish a set of mutually agreed criteria to avoid market disruption and unfair competition, *to* ensure reciprocal rights in the field of acquisition of carriers and an effective mechanism for resolving disputes.[48] However, the Council of Ministers was not able to reach agreement on this proposal until July 1996 when the Commission was given a mandate to negotiate an EU-wide agreement. This mandate did not cover all issues and several member states continued to negotiate *open skies* agreements with the US which have further weakened the EU's negotiating position.[49]

In 1996, the British government again planned to sign an open skies agreement with the US government to pave the way for a code-sharing alliance between British Airways and American Airlines (AA). The present Commissioner responsible for competition, Karel Van Miert, had already warned the British government earlier in 1996, as Neil Kinnock had warned the seven member states in 1995, not to approve the agreement between BA and AA and not to enter into a bilateral agreement with the US. On 3 July 1996, the Commission started proceedings under Article 89 of the EC Treaty in order to examine whether the alliance was compatible with EC competition rules. In December 1997, the Commission decided to initiate the second phase of the breach of Treaty proceedings against eight member states: Germany, Austria, Belgium, Denmark, Finland, Luxembourg, United Kingdom and Sweden. The proceedings followed the letters of formal notice in 1995, and are called the *reasoned opinion* stage under Article 169.[50]

48 Commission Communication IP/95/414, 26 April 1995.

49 Commission Communication, "The way forward for civil aviation in Europe" COM (94) 218 final. Commission Communication IP/98/231, 11 March 1998.

50 *The European*, 16-22 January 1997, pp. 1 and 17. The BA-AA alliance is described in more detail below in Part II, chapter 4 B. Commission Communication IP/98/231, 11 March 1998.

2. From regulation to liberalization in the EC

A. Background

Following the failure of the 1944 Chicago Convention to establish a multilateral regime for the exchange of international traffic rights, the European governments set up their own regulatory systems for their fledgling air transport industries. These systems were constructed with the basic aim of protecting the national flag carriers, most of which were publicly owned, from competition. This was done by controlling market entry on both domestic and international routes. In most instances this gave the flag carrier a virtual monopoly on air transport in its own national state as the flag carrier was, with very few exceptions, the sole designated operator within that country. When it came to international air transport services, each route was normally serviced by two flag carriers. These carriers were granted a licence to operate by the licensing authorities in each carrier country according to the bilateral agreement (to be referred to below) with the partner country. Thus SAS and Air France, for example, would be designated to operate the route between Copenhagen and Paris. This did not mean that SAS and Air France competed with one another on this route, on the contrary, they and all the other licence holders on the international routes in Europe colluded to avoid any kind of competition and very often pooled revenue. The absence of competition led to operative inefficiency, necessitating high fares, since the international system worked in such a way as to set the fare level in relation to the cost of the least efficient operator on a route. A large increase in capacity on many scheduled routes in the early 1970s and the advent of wide-body aircraft forced carriers to find ways to increase demand. No individual flag carrier was interested in reducing fares, what they wanted was to retain the existing level of fares while at the same time generating new business. The problem was solved by on one hand retaining the sale of flight tickets through authorized travel agents at the approved price level, and on the other hand selling tickets through non-authorized travel agents at an illegally discounted fare. Such tickets were dumped on the market at short notice by airlines with spare capacity.[51] Even though this practice was maintained throughout the 1970s and much of the 1980s, eventually it could be upheld no longer. As a response to consumer pressure groups, which since the end of the 1970s had been calling for lower prices on air transport, the carriers eventually began to differentiate between economy class passengers paying discount prices and the high fare paying clientele. The differentiation came about with the introduction of business class.

Over the years, a tight international network of bilateral air transport agreements concerning scheduled air services developed between almost all countries of the world. They usually contain provisions which regulate market access, the number and scope of air transport rights, capacity and tariffs. Almost all bilateral agreements restricted competition between airlines to a greater or lesser extent well into the 1980s. In Europe, however, the tendency during this period was towards more liberal bilateral air transport agreements. In particular, the British government negotiated pro-competitive bilateral air transport agreements with the Netherlands, Belgium and the Federal Republic of Germany. These agreements were all

51 Holloway, J.C., *op. cit.*, p. 81.

modelled after the agreement between the UK and Luxembourg of 21 March 1985, the so-called Air Route Agreement.[52] This agreement provided for a dismantling of market access and capacity restrictions, as well as the double disapproval procedure for tariffs. According to this procedure, a tariff proposed by an airline became effective unless the governments of both countries voiced their disapproval within an agreed period of time. However, such bilateral agreements could not in themselves accomplish liberalization within the Community, because not all the member states were prepared to agree to similar - let alone more liberal - measures. Action at Community level was required.

In the terms of the EC Treaty, air transport involves the provision of a service provided by an airline company in the form of transport by air. This means that - in the absence of special provisions - air transport falls under the following provisions in the EC Treaty: the right of establishment (Articles 52-58), services (Articles 59-66), transport (Articles 74-84), competition and state aid (Articles 85-94). However, the provision of Article 61(1) lays down that the freedom to provide service in the field of transport is governed by the provisions of the Treaty relating to transport, i.e. Articles 74-84. Thus transport - including air transport - is to be governed by the Treaty's provisions on transport exclusively. Moreover, when the Treaty of Rome was signed in 1957, air (and sea) transport were excluded from the general transport policy provisions of the Treaty. Instead, Article 84(2) provides that air (and sea) transport policy measures shall be taken as and when the Council so decides. At that time the reasons for singling out air transport for special treatment were not only that all the member states had national airlines which were wholly or substantially state owned, but also the important social and economic role of transport in general and air transport in particular in providing domestic, interstate and international links. The wider international context represented by the Chicago Convention, the ICAO and IATA was also important. The period lasting from the original signing of the Treaty in 1957 to the coming into operation of the Single European Act in 1987 is described by John Balfour as follows:

> *... when the Treaty of Rome was signed in 1957, the Member States did not feel ready to include air transport in the various sectors in which national barriers were to be removed. The Commission made some early attempts to apply Treaty provisions and objectives to air transport, in particular with the publication of its first memorandum on the subject in 1979, but this achieved little in practical terms. Certain minor initiatives took place over the following years, perhaps most notably the Council Directive liberalizing scheduled inter-regional services to some extent, but, although this was the first EC measure liberalizing air services multilaterally within the Community, its aims and its practical effects, were severely limited.*[53]

As the Council had used its powers under Article 84(2) with a great deal of reluctance, the European Parliament took the Council to court under Article 175 of the Treaty for its inactivity in the entire area of transport policy in 1983. In 1985, the European Court of Justice held

52 Ebke, W. and G. Wenglorz, *op. cit.*, p. 500.

53 Balfour, John, Air Transport - A Community Success Story? in *Common Market Law Review* (1994), Vol. 31, p. 1026.

partly in favour of the European Parliament.[54] As a result, only a few months after the Court's decision, the Council presented its so-called *Master Plan Concerning Transport Policy*[55] and accepted the proposals made in the Commission's White Paper on the Completion of the Internal Market,[56] both of which affected air transport.

Under the influence of deregulation of domestic air transport in the US in 1978 as well as the decision of the European Court of Justice in the so-called *Nouvelles Frontières* case[57] and the signing of the Single European Act, both in 1986, the Council's change of attitude became manifest: it became the Council's aim to achieve an internal market in the air transport sector. This object was attained in two different but complimentary ways:

> … - *on the one hand, by policy legislation, under Article 84(2), aimed at Member States, intended gradually to break down the various restrictions which existed on competition between airlines from pairs of States and then to abolish national barriers and move from a bilateral to a multilateral system; and on the other, by means of application of the competition rules so as to eliminate the anti-competitive arrangements between airlines which had traditionally so characterized the industry.*[58]

The Council legislation passed under Article 84(2) to abolish the many bilateral restrictions on competition and the move from a bilateral to a multilateral system is described below under B and C. The application of competition rules to eliminate the anticompetitive agreements between airline companies will be described below under D.

B. From the first to the third package

The Single European Act came into operation on 1 July 1987. The liberalization of air transport envisaged in the Act was begun, though it was done stage by stage because of the different positions which the member states took towards liberalization. Among these, the UK,

54 Case *European Parliament v. Council*, case 13/83 [1985] ECR 1513 [1986] 1 CMLR 138.

55 Bull. Eur. Comm. 11/85 (1985).

56 Commission White Paper of 14 March 1985, (COM (85) 310 final).

57 Joined Cases 209-213/84, *Ministère Public v. Lucas Asjes and Others*, [1986] ECR 1425 [1986] 3 CMLR 173.The ECJ considered whether it was in accordance with Treaty provisions, especially the competition provisions, that tariffs for air transport were subject to approval by the French Government. The Tribunal de Police de Paris had asked the ECJ for a preliminary ruling in connection with a criminal court case against several airline companies and travel agencies selling flight tickets at fares below the tariffs agreed upon by IATA and approved by the French ministry of transport. The Court ruled that the competition provisions in Articles 85-90 also apply in the area of transport and that air transport - like other forms of transport - is subject to the Treaty's general provisions including those on competition. However, in the absence of implementing regulations as required by Article 87 of the Treaty, Articles 85 and 86 could not be enforced directly by the Commission or the member states. Pointing to Articles 88 and 89 of the Treaty, the Court suggested that the Commission take appropriate measures to enforce the general principles underlying Articles 85 and 86, even though the enforcement procedure of Articles 88 and 89 is not capable of assuring complete compliance with Articles 85 and 86. The Commission complied with the Court's views of the Commission's responsibilities under Article 89, by proceeding against ten major European airlines for contravening Article 85. The airlines agreed to bring their tariff, capacity and pooling agreements into compliance with Article 85 (see Ebke and Wenglorz, *op. cit.*, p. 509).

58 Balfour, John, *op. cit.*, p. 1027.

the Netherlands and Eire were the foremost advocates of liberalization; Germany, France, Spain and Italy on the other hand, with their state-owned and heavily subsidized national flag carriers, were at the rear. The process of liberalization was carried out in three stages, each stage usually termed the first, second and third packages, respectively. The first package was adopted by the Council in 1987, the second in 1990 and the third in June 1992.

The *first package* adopted in December 1987 contained regulations laying down the procedure for the application of competition rules to the air transport sector, as a result of which Articles 85 and 86 may be fully applied to all air transport within the Community.[59] The Commission was given powers to grant block exemptions for certain agreements between airlines on capacity and revenue sharing, non-binding tariff consultations and access to airport facilities.[60] A system was also introduced for the approval of air fares by member states which allowed for flexible pricing together with a relaxation of capacity controls between member states and freer market entry.[61]

The *second package*, which came into operation on 1 November 1990, included provisions for further relaxation of the requirement for fare approvals by national governments, allowing the designation of several carriers on certain routes and providing access to third, fourth and fifth freedom traffic rights on scheduled flights within the Community. In addition, quota sharing of passengers was progressively abolished.[62]

The great leap forward took place on 23 June 1992 when the Council adopted three regulations which together form the *third package*.[63] The completion of the internal market was due to be completed at the same time as the third phase of the Commission's programme to liberalize air transport in the EC came into operation, with the result that airlines could no longer rely on government protection and had to adapt to the more competitive environment in which the rules of the market determine success or failure.

The provisions of the third package meant first of all that free tariff-fixing was allowed from 1 January 1993 subject to certain safeguards to prevent excessively high or low fares.[64] The development of the market since the beginning of 1993 has been characterized by the airlines marketing a great variety of fares at special prices or fares with a special time-limited discount. Special prices and discounts are marketed as alternatives to the tariff prices but do not substitute for them. Generally, airlines now operate three categories of fares: 1) full fare prices on economy, business and first class; 2) special fares such as APEX (advance purchase

59 Council Regulation No. EEC/3975/87 (O.J. 1987 L 374/1).

60 Council Regulation No. EEC/3976/87 (O.J. 1987 L 374/9). Both Regulation No. 3975 and No. 3976/87 were adopted under Article 87 of the Treaty. The Commission issued block exemptions in three Regulations, Nos 2671-2673/88.

61 Council Directive No. 87/601/EEC (O.J. 1987 L 374/12) and Council Decision No. 87/602/EEC (O.J. 1987 L 374/19).

62 Council Regulations No. EEC/2342/90 and No. EEC/2343/90 (O.J. 1990 L 217/1 and 8).

63 Council Regulations No. EEC/2407/92, No. 2408/92 and No. 2409/92 (O.J. 1992 L 240/1, 8 and 15).

64 In such cases, the member states may ask the Commission to examine the fare and decide whether or not the Commission can approve it (Council Regulation No EEC/2409/92).

excursion ticket) and PEX (purchase excursion ticket); 3) discount prices with time limits. The special fares and discount prices (2 and 3) are usually made subject to a number of restrictions, as they have to be booked in advance, the booking can neither be altered nor cancelled, and the number of seats available is limited. However, two policies can be distinguished on the European market: one is employed by the big, established airlines. They compete for market shares by offering a great variety of discounted fares on selected flights during limited seasons and on a limited number of seats. Smaller airlines with fewer routes and less flight frequency make use of the policy of offering discounted fares on all their flights. Virgin Express and Ryanair make use of this practice. The net result has been that the new access to price competition has led to new price discounts but not to a reduction of tariff prices.[65]

Second, a Community-wide procedure for licensing carriers was introduced, which meant that any airline which met the specified requirements must be granted an operating licence.[66]

> *The regulation on licensing is at first sight a regulatory measure … However, its main importance is as a liberatory measure, because any airline which meets the specified requirements as to financial fitness, technical fitness and nationality of ownership and control, must be granted an operating licence. In other words, Member States are no longer allowed to continue the monopoly policies which they often previously operated in respect of national carriers: if an airline satisfies the basic requirements it must be granted a licence by its home Member State and then be allowed to operate to almost any destination within the Community. Another very important change brought about by the licensing regulation comes from the requirement of nationality of ownership and control. Previously it was universally the case in Member States (and still is in most of the rest of the world) that any local airline had to be owned and controlled by nationals of that State. The licensing regulation replaces this by a requirement that an airline licensed by a Member State must be owned and controlled by nationals of any Member State. When read together with the provision that any airline which satisfies the requirements [as to financial and technical fitness], must be allowed to operate within the community, this means that airlines and nationals from one Member State may set up or take over an airline in any other Member State which is truly a radical change*.[67]

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65 The number of passengers travelling by air on discounted fares has increased from 60.5 per cent in 1985 to 70.9 per cent in 1995. As the market for charter flights represents around 50 to 55 per cent of the total market, it is estimated that 90 to 95 per cent of all passengers travel with a discounted fare or a special price ticket. On the market within the EC served by more than two airline companies (6 per cent of the total market, see below), a tendency to compete by reducing fares has been noticeable. In the United Kingdom, British Midland has introduced a "price war" leading to a price reduction of 10-20 per cent on business class prices on the London-Amsterdam/Paris/Brussels/Frankfurt routes during the period 1992-1995. That is also the case on the routes from Belgium served by Eurobelgian/Virgin Express. See Report from the European Commission to the Council and the Parliament, *The Effects of the Third Package for the Liberalization of Air Transport*, Report of 22 October 1996 COM (96) 514 final, pp. 4-5.

66 In Council Regulation No. EEC/2407/92 (O.J. No. 1992 L 240/1).

67 Balfour, John, *op. cit.*, pp. 1028-1029.

The regulation on access requires member states to allow any licensed Community carrier to operate between any two points within the Community.[68] During the period 1993-95, the member states have issued 800 licences - most of them to small operators. Some of the licences have again been withdrawn, withdrawal being caused either by financial difficulties or bankruptcy of the licensee in question. The common goal has been to protect the European flight industry and to prevent foreign airline companies from profiting from the liberalization of the European market - in view of the fact that European airline companies are barred from investing freely outside the European Community. Within the Community, the new entry of small and medium sized airline companies is noticeable, but of the 80 new companies 60 have been either withdrawn or taken over by the established airlines. With the exception of the United Kingdom, all the member states own considerable shares in their *national airline companies*. The third package has eliminated the distinction between airline companies operating scheduled flights and airline companies specializing in charter flights. Charter companies may now offer flights to consumers without combining them with other services at the points of departure and destination. They may establish themselves anywhere within the Community just like the airlines operating scheduled flights. Many charter companies - such as Air Europa, Spanair, Air Liberté and others - have made use of this opportunity to penetrate the market for scheduled flights, even though they still operate as charter companies, thus offering the established airlines considerable competition. Accordingly, the market shares of charter companies have grown. The charter traffic to some destinations in Spain and Greece has grown to cover 80 per cent of the total traffic to these destinations. Some charter companies are affiliated to a national airline, such as Sobelair to Sabena and Condor to Lufthansa, others are affiliated to or controlled by some of the larger travel organizers. The third package has had another effect in that many airline companies have begun to cooperate and make alliances in various ways. This will be described in greater detail below in Chapter 4.[69]

Third, the remaining restrictions on cabotage, which applied during the transitional period starting on 1 January 1993, were removed from 1 April 1997.[70] This is considered to be the corner stone of the third package, as it is now possible to put an end to the bilateral exchange of traffic rights and to introduce the multilateral system within the Community itself - but not in relationships with third countries.[71] The Commission hopes that the many routes within the Community which are still served inefficiently or not at all will provide opportunities for new entrant airlines, as the prognosis for success is good because of the absence of competition on such routes.[72] The third package has already been successful in the sense that the number of airlines in the EC has increased in the intervening three and a half years, but not in the sense of

68 Council Regulation No. EEC/2408/92.

69 Report of the Commission of 22 October 1996 COM (96) 514 final, pp. 16-19.

70 See Council Regulation No. EEC/2408/92. The reason why cabotage was not liberalized completely until 1 April 1997 was strong resistance from the larger EC countries, which at the time when the third package came into operation were not ready to open their domestic markets and to allow competition on busy routes. See Lewis, Claire Simone, EC Air Transport Policy: Third Package Proposals for Liberalisation in *EIU European Trends*, No. 2, 1992, p. 42.

71 Report of the Commission of 22 October 1996 COM (96) 514 final, p. 8.

72 Report of the Commission of 22 October 1996 COM (96) 514 final, p. 1e.

increased competitiveness on routes dominated by the big, established airlines. Thus, 94 per cent of the routes within the Community were still mono- or duopolized in 1996. New entrant airlines have been forced to use a lot of resources just to stay in the market and the established airlines have not experienced the increase in competition they were expected to. However, the number of routes has increased since 1993, though not to any really significant extent.[73]

C. After the third package

The Commission considers that the internal market for air transport is still very fragile, to the extent that it is incomplete because of the bilateral agreements between member states in the Community and third countries and a number of other factors. The agreements with third countries often contain provisions which do not conform to the regulation of the internal market, such as provisions for the designation of a national airline to serve on routes covered by the agreement. This entails that the pressure of competition between airlines on the internal market is slackened.[74] Other, more practical obstacles to the third package having its full effect exist. One of these concerns the infrastructure which will be insufficient if the expected increase in passenger flight traffic takes place within the next eight years. More than ten European airports will not have sufficient capacity in respect of landing and take-off by the year 2005. Another obstacle is the limited access to ground handling services which many national airports and national airport authorities have imposed, to the effect that either the national airline, a subsidiary or an independent company has a monopoly on these services. The lack of harmonization in the social and tax legislation of the member states also causes problems. All of which has led to the Commission's proposals to take action to 1) extend the

73 In January 1993, there were 488 *routes* between airports within the EC. In 1996, the number had increased to 518. In 1993, of the 488 routes 296 (61 per cent) were flown by airlines with a monopoly, 182 routes (37 per cent) were duopolized, and 10 routes (2 per cent) were flown by more than two airlines. In 1996, of the 518 routes 329 (64 per cent) routes were flown by airlines with a monopoly, 158 routes (30 per cent) were duopolized, and 31 routes (6 per cent) were flown by more than two airlines. Thus the number of duopolized routes has decreased, whereas the number of routes served by either one airline with a monopoly or by several airlines has increased, respectively. However, the *frequency of flights* on the routes served by more than two airlines has increased from 12 per cent in 1992 to 16 per cent at the beginning of 1996, including flights on the busy routes between Heathrow-Roissy, Dublin-Heathrow, Stockholm-Copenhagen and Brussels-Rome. In 1996, 30 routes were served under the fifth freedom of the air compared with 14 in 1993. There were no cabotage routes in 1993, but the figure was 30 in 1996 (see the Commission's Report of 22 October 1996 COM (96) 514 final, pp. 1a and 9).

74 The Commission has suggested that such bilateral agreements with third countries should be renegotiated and their anticompetitive effects controlled. Accordingly, the Council has authorized that Community negotiations be carried out with the United States and with some of the associated countries in Central Europe. (The Commission's Report of 22 October 1996 COM (96) 514 final, p. 22).

two block exemptions concerning slot allocation and computer reservation systems;[75] 2) update the Code of Conduct for the computer reservation systems introduced in 1989;[76] 3) gradually liberalize access to ground handling services.[77]

D. Competition rules

It has already been mentioned above that proposals for the application of Articles 85 and 86 of the EC Treaty on air transport were adopted as part of the first package in 1987 in Council Regulations 3975 and 3976/87. Council Regulation 3975/87 implemented Articles 85 and 86 with regard to international air transport between member states in much the same terms as Regulation 17/62, though there were slight differences. Council Regulation 3976/87 empowered the Commission to grant block exemptions from the prohibition in Article 85(1) under 85(3) for certain kinds of agreements, decisions and concerted practices. In 1988, the Commission issued three such block exemptions in Regulations 2671-2673/88 concerning capacity planning, revenue sharing, tariff consultation, slot allocation, computer reservation systems and ground handling services, in each case subject to detailed conditions. These block exemptions have been updated and those now in force expire on 30 June 1998. The most recent developments in this area are referred to immediately above.

The legislation adopted in the first package applied only to international air transport between member states. But in April 1989, the European Court of Justice delivered a judgment in the Ahmed Saeed Flugreisen case, which established for the first time that in principle the competition rules apply also to domestic air transport and to air transport between member states and third countries. According to the judgment, bilateral or multilateral price fixing agreements between airline companies applying to flights between airports in one member state (domestic flights) or to flights between an airport in a member state and an airport in a third country are void as laid down in Article 85(2), once either the Commission or the competition authority in the member state of the airline company or companies in question has ruled that the agreement infringes the prohibition in Article 85(1). Similarly, such agreements

75 Commission Regulations No. 2671 and No. 2672/88. The block exemption concerning co-operation between airlines including slot allocation was updated in 1993, when the Commission issued a new regulation in this area (Commission Regulation No. EEC/1617/93 (O.J. No. L 155 of 26 June 1993). The Regulation came into operation on 1 July 1993 and applies for a period of five years until 30 June 1998. In July 1989, the Council adopted a Regulation establishing a code of conduct for computerized reservation systems No. EEC/2299/89 (O.J. No. L 220 of 29 July 1989). Computerized reservation systems (CRSs) contain, inter alia, information about schedules, availability and fares. As the code of conduct constituted a completely new area of legislation, without any prior practical experience, when it came into operation there were some difficulties of application. In 1993, the Commission presented a proposal amending Regulation No. 2299/89, which was adopted by the Council on 29 October 1993 as Council Regulation No. EEC/3089/93 (O.J. No. L 278 of 11 November 1993, p. 1). A new block exemption for CRSs, which replaced the former block exemption (No. 83/91 which had replaced No. 2672/88) was adopted by the Commission at the end of 1993. It covers agreements between companies for the purposes of purchasing, developing or marketing a common CRS. The Regulation came into operation on 1 January 1994 and expires on 30 June 1998 (Commission Regulation No. EC/3652/93 (O.J. No. L 333 of 31 December 1993).

76 Council Regulation No. EEC/2299/89 (O.J. No. L 220).

77 In 1996, the Council passed a directive to the effect that agreements about ground handling services were no longer exempt from Article 85(1) of the Treaty. Commission Report of 22 October 1996 COM (96) 514 final, pp. 1d and 26.

may also represent an abuse of a dominant position on the market under Article 86, particularly if the airline companies with a dominant position are able to force other transport businesses to fix their prices at exorbitantly high or low levels or to use only one price on a route. Finally the Court ruled that Articles 5 and 90 in the Treaty must be understood so as to prohibit a national authority from authorizing price agreements, which are in contravention of Articles 85 or 86. An exception is that the national authorities in question may limit the effect of the competition rules and authorize prices, if this is absolutely necessary for the general welfare of society and concerns a task imposed upon an airline, e.g. to fly on a particular, unprofitable route, on condition that the task and its consequences for the price structure on the market have been clearly understood.[78] This encouraged the Commission to put forward proposals for the revision of Regulations 3975 and 3976/87 in order to grant the Commission powers to clarify how Articles 85 and 86 apply to domestic flights and flights between airports in the community and third countries. These proposals were part of the second package and will be described below.

As far as the competition rules are concerned, the only amendment of any substance made by the second package in 1990 was an extension of Council Regulation 3976/87, concerning the issue of block exemptions, adding consultations on cargo rates as a further category of agreement eligible for block exemption.[79] The period of validity of the block exemptions already issued by the Commission was also extended until 31 December 1992.[80] The Commission then issued three block exemptions to replace and modify the first three from the first package.[81]

The third package of 1992 contained two regulations relating to the competition rules. One extended the scope of the existing implementing regulation to cover domestic air transport within a member state.[82] The other similarly extended the scope of the existing regulations authorizing block exemptions, made some changes to the categories of agreement for which

78 Case 66/86, *Ahmed Saeed Flugreisen and Silverline Reisebüro v. Zentrale zur Bekämpfung unlauteren Wettbewerbs EV*, [1989] ECR 803 [1990] 4 CMLR 102. In this case, the Court considered the legality of the sale of flight tickets used for departure from a German airport, even though the ticket itself stated that departure was to take place from another EC country, where the ticket was bought at a lower price than if it had been bought in Germany. The German Bundesgerichthof had asked the ECJ for a preliminary ruling in connection with a German court case in which the German marketing practices authority had sued two travel organizers. The travel organizers had bought the flight tickets from either airline companies or travel organizers in another member state and the tickets were payable in the currency of that other member state. By selling such tickets, the two travel organizers had infringed German air transport legislation, which prohibited the use of ticket prices not authorized by the German Minister of Commerce. The two travel organizers were also sued for disloyal marketing practices, as the price of the tickets which they sold was lower than those authorized prices which the competing travel organizers used.

79 Council Regulation (Reg. No. EEC/294/91) on the operation of air cargo services between member states. The Council also adopted a regulation to give the Commission specific powers to take interim measures against anticompetitive practices in appropriate cases in an air transport context (Reg. No. EEC/1284/91). The ECJ had already confirmed that the Commission had powers to take interim measures generally.

80 Council Regulation No. EEC/2344/90 (O.J. 1990 No. L 217/15).

81 Commission Regulations Nos 82-84/91 (O.J. 1991 No. L 10/7).

82 Council Regulation (EEC) 2410/92 (O.J. 1992 No. L 240/18).

block exemptions could be issued and again extended the period of validity of the block exemptions already adopted beyond the end of 1992.[83]

To sum up, the application of the competition rules to air transport is governed by three different regimes. 1) Articles 85 and 86 are fully applicable to all air transport within the Community as a result of Council Regulation 3975/87. 2) Because there is no implementing regulation for air transport between member states and third countries such air transport is governed by the *interim regime* referred to in the *Nouvelles Frontières* case and provided by Articles 88 and 89.[84] 3) The special regime for the application of the competition rules to air transport within the Community only applies to *air transport* as such. Any other activity connected with air transport, but not itself constituting air transport, is governed by the general implementing competition regulation, Council Regulation No. 17/62.[85]

83 Council Regulation (EEC) 2411/92 (O.J. 1992 L 240/19).

84 This means that the national competition authorities of the member states and the Commission may apply the rules in Articles 85 and 86 in this area; an agreement is automatically void under Article 85, and a national court may not apply Article 85 unless and until the Commission or the national competition authorities of a member state have taken such a decision; Article 86 is directly applicable without any such prior decision and may be applied by the national courts (see Balfour, *op. cit*. pp. 1034-1035).

85 Ibid.

3. Privatization and state aid

A. Privatization

The philosophy of reduced governmental involvement which led to liberalization of the airline industry in Europe also had another aspect, represented by the movement away from state ownership of airlines towards private ownership. Many European airline companies in the EC have thus been following a policy of total or partial privatization. The first airlines to be privatized were British Airways in the UK and KLM in the Netherlands.

> *KLM was the first European airline to be privatised in a programme which started in 1986. At the time, KLM was a limited company quoted on the Dutch stock exchange and was in an ideal situation for privatisation. The equity participation of the company was shared with a majority private sector capital and a smaller but significant participation by the Dutch government. Being quoted on the stock exchange gave an accurate indication of the stock market value of the company.*[86]

KLM was privatized in three simultaneous operations: 1) The company bought a large part of the shares (3 million) owned by the government, so that the government now owns only 39 per cent of KLM's registered capital; 2) these shares were immediately sold through a banking syndicate which was appointed to put them on the market together with 3) 12 million new shares issued to increase the registered capital of the company.[87]

British Airways is the largest airline company in Europe. Since BA started co-operation with USAir in 1993 by securing a 24.6 per cent stake in USAir, the sixth largest carrier in the US, BA became one of the largest airlines in the world.[88] The privatization of British Airways in February 1987 is the largest privatization programme ever of an airline company. All the government shares in the company, which amounted to £900 million, were transferred to the private sector. It took seven years for the process to be completed. During this period, it was necessary to change the whole economic and financial situation of British Airways, to promote a new corporate image and to implement a programme of modernization and rationalization. These measures contributed towards improving British Airways' financial situation and its debt was reduced accordingly. The transfer of shares to the private sector was organized by a public offer of shares on the British financial market as well as on foreign markets. The shares were put on the market on certain conditions according to which 42 per cent were reserved for British institutional investors, 10 per cent for the 40,000 employees and retired BA staff at a 10 per cent discount, 28 per cent were offered to the public, and 20 per cent were allocated to foreign investors. The purpose of the distribution of shares was to provide a nucleus of institutional shareholders, an involvement in the company by the general public and British

86 Vellas, F. and L. Bécherel, *op. cit.*, p. 153.
87 Ibid.
88 Seaton, A.V. and M.M. Bennett, *The Marketing of Tourism Products: Concepts, Issues and Cases*, International Thomson Business Press, London, UK and Boston, Mass, 1996, p. 394.

Airways staff as well as international interest. In 1996, the number of private investors in BA amounted to 235,000, among them 65 per cent of the company's own employees.[89]

National ownership of the SAS Group in Scandinavia is shared between Denmark and Norway each with a 2/7 share and Sweden with a 3/7 share. The SAS Group is thus divided into three companies: SAS Denmark Ltd., in which the Danish government owns 50 per cent of the shares, the other 50 per cent being owned by private investors. SAS Denmark shares are listed on the Copenhagen stock exchange. The shares of SAS Norway Ltd. are divided into equal numbers of A and B shares, all the A shares being held by the Norwegian government, while B shares are owned by private investors and traded on the Oslo stock exchange. Approximately 20 per cent of these are held by foreign investors. SAS Sweden Ltd. is 50 per cent government owned and 50 per cent owned by Swedish institutions, listed Swedish companies and private investors.[90] Lufthansa in Germany - or Deutsche Lufthansa AG - has also been privatized and is now largely a privately owned company. The German government currently owns 35.68 per cent of the shares, but plans to sell its remaining shares as soon as the necessary preconditions have been established. Private investors own 49.30 per cent of the shares. The remaining 15.02 per cent of the shares are owned by the Kreditanstalt für Wiederaufbau, the State of Nord-Rhein-Westfalen, the German Post Bank, German Rail and the Gesellschaft für Luftverkehrswerte, the last mentioned owning 10.05 per cent, the others less than 2 per cent each.[91] Swissair is privatized to an even greater extent, with a minority of 20 per cent government ownership.[92] Air France, on the other hand, is 100 per cent owned by the French state and has received large subsidies from the French government over the years. A restructuring plan was launched to improve the airline's productivity and to streamline the company in 1993, when it had a deficit of enormous proportions. The airline improved its performance during the years 1993-96 as a result of personnel reductions, group restructuring and a general reduction of operating costs and expects to break even in 1997.[93] European airline companies such as Alitalia, Olympic Airways and Iberia are still largely public-sector owned: in 1992 Alitalia by 84.9 per cent, Olympic Airways and Iberia by 100 per cent public-sector capital.[94]

B. State aid

The rules on state aid are contained in Articles 92-94 of the EC Treaty. For a long time these rules were not applied in the air transport sector, although the Commission had published guidelines on their application as early as in 1984 in its second memorandum *Progress*

89 Vellas, F. and L. Bécherel, *op. cit.*, p. 154, Seaton, A.V. and M.M. Bennett, *op. cit.*, p. 394, British Airways Fact Book 1996, p. 12 and pp. 30-36 and British Airways Report and Accounts 1995-96, p. 1 and pp. 5-6. The alliance with USAir has since been terminated by British Airways. It is being replaced by an agreement with American Airlines, see chapter 4 B, at note 123.

90 SAS Annual Report 1995 and Report for the period 1 January-30 September 1996.

91 Lufthansa Facts and Figures 1996, p. 14.

92 Eaton, Jack, Flying the Flag For Subsidies - Prospects for Airline Deregulation in Europe in *Intereconomics*, May/June 1996, p. 149.

93 Air France, Presentation of Financial Results for the Year ended 31 March 1996, pp. 20-25 and the 1995-1996 Annual Report, p. 21 and pp. 26-27.

94 Vellas, F. and L. Bécherel, *op. cit.*, p. 156.

towards the development of a Community air transport policy.[95] Furthermore, it had been clear since the *Nouvelles Frontières* judgment in 1986 that the state aid rules applied fully to air transport. However, there was little point in applying these rules while the conditions of competition among the airline companies in other respects were so unequal. But as John Balfour puts it: *There was arguably little point in applying the state rules while the conditions of competition among airlines in other respects were still so unequal, but as that began to change, so did the Commission's attitude to the enforcement of the rules*[96]

In February 1994, the research group appointed by the Commission, known as the *Comité des Sages*, handed over its final report. The research group had been appointed by the Commission in 1993 to analyse the problems of the air transport sector and put forward proposals which would enable the Commission to prepare a concerted action programme aimed at improving the competitiveness of the European airline industry.[97] The Committee was of the opinion that the main causes of the financial crisis in the air transport sector were the fragmentation of the European airline markets and the inefficiency of many of the national air transport systems, in which national carriers were used by governments as instruments to promote national interests, all of which led to low productivity and high operating costs. The Committee recommended effective enforcements of the provisions for the internal market by addressing sensitive issues like, for example, state aid, mergers and alliances. As regards state aid in particular, the Committee recommended that the Commission's *one time/last time approach* be implemented strictly, so that state aid could only be granted in exceptional circumstances and for restructuring purposes only. Later in 1994, the Commission issued a Communication called *The way forward for civil aviation in Europe* as a follow-up to the report of the *Comité des Sages*, in which the Commission reaffirmed that state aid for the restructuring of air carriers could only be accepted if it did not distort or threaten to distort competition.[98] In November 1994, the Commission adopted a series of guidelines for state aid which reflected the completion of the internal market for air transport and was intended to increase transparency at different levels of the evaluation process.[99]

Article 92 of the EC Treaty prohibits state aid as *incompatible with the common market* when it distorts or threatens competition by favouring certain undertakings or the production of certain goods, except in certain exceptional circumstances, such as aid having a social character, aid to make good damage caused by natural disasters and aid granted to the former

95 Second Memorandum of 15 March 1984, COM(84) 72 final.

96 Balfour, J., *op. cit.*, p. 1039.

97 The Report was entitled *Expanding Horizons - Civil Aviation in Europe, an Action Programme for the Future* (IP/94/54, 1 February 1994). The chairman of the Committee was Herman De Croo, former Belgian Minister of Transport, and 11 other members represented the various interests involved. Members were, for example, the presidents of KLM and Maersk Air, the chairman of the Executive Board of Lufthansa, the chairman of the Joint Civil Aviation Council, the Chairman of the Board of Amadeus, one of the European CRSs, and the president of the World Travel & Tourism Council.

98 Commission Communication COM (94) 218 final.

99 Commission Communication P/94/66, 16 November 1994. The requirements were that: 1) aid should be part of a comprehensive restructuring programme; 2) capacity reductions must be included; 3) aid must not aim to increase capacity to the detriment of other European carriers; 4) a national government must not interfere in the management of the company; 5) aid must be controlled and transparent.

East Germany. Aid may be considered compatible with the common market, if it is granted to promote the economic development of areas where the standard of living is abnormally low, to promote a project of common European interest or to facilitate the development of certain economic activities. State aid to airlines, when permitted, usually falls under the last-mentioned clause. Article 93 contains the procedural rules for the Commission and Article 94 authorizes the Council to make regulations for the application of Articles 92 and 93.

The Commission's first major investigation took place in 1991, when the Commission approved the giving of aid to Sabena by the Belgian government, but subject to certain conditions designed to ensure that the aid was part of a restructuring package, namely that the Belgian government would not interfere in the management of Sabena and that the aid should be the last.[100] In 1991 and 1992, the Commission examined two cases of the grant of state aid to Air France. In each case, it found that the injections did not constitute aid, because they were such as might have been made by an ordinary private investor under normal market economy principles, chiefly on the basis that at that time Air France seemed to provide a good investment opportunity. In 1992, the Commission considered that the financial help of the Spanish government to its national airline Iberia was a case of state aid - not an investment - to finance an ambitious expansion programme in Central and South America. The Commission allowed it, but imposed conditions similar to those imposed in the Sabena case. The Commission did not issue formal decisions in the Air France and Iberia cases, only brief press releases describing the reasons for its conclusions.[101] In 1993, the Commission made a formal decision concerning state aid granted by the Portuguese government to its national airline, TAP. The aid was granted in the form of exemption from corporate income tax. The Portuguese government argued that the grant of this aid was justified by the fact that the airline systematically showed losses, and therefore no corporate income tax could be applicable in any case. The Commission, on the other hand, emphasized that, in principle, tax exemptions granted to natural or legal persons constitute state aid under Article 92 of the Treaty. The Commission felt that the tax exemption benefitting TAP strengthened the competitive position of the airline vis-à-vis other Community carriers which were subject to tax burdens and affected intra-Community trade. Under these conditions, the Commission called on the Portuguese government to withdraw the aid in question.[102]

After the publication of the report of the Comité des Sages in 1994, the Commission authorized the grant of state aid in the following instances: state aid provided by the Irish government to the Aer Lingus group in 1994, given in the form of £Irl 175 million equity injection, awarded in three tranches over a period of three years. The Commission referred to the exception in Article 92(3)(c), in other words, aid to facilitate the development of certain economic activities. The airline's difficulties resulted from expanding its fleet during the 1980s, just before demand for air travel declined at the time of the Gulf War and recessions in the American and European economies. In addition, Aer Lingus had been used as a vehicle for regional development policy, including the obligation that all transatlantic flights make a

100 Commission Decision, O.J. 1991, L 300/48.
101 Balfour, J., *op. cit.*, p. 1040.
102 Commission Decision, O.J. No. C 163 of 15 June 1993, p. 5.

stopover in Shannon and by operating unprofitable domestic routes. The restructuring plan required direct scheduled flights between Dublin and the USA, 1500 redundancies and the sale of subsidiaries.[103] The Irish government confirmed that the money granted would be used entirely to meet restructuring costs and reduce the debts of Aer Lingus in order to restore the company's financial position. The Commission prohibited the Irish government from granting any further aid to Aer Lingus. It also made it a condition that capacity be constrained on routes between Dublin and London in response to a vigorous complaint by British Midland that the aid should not be used to allow Aer Lingus to compete unfairly with it on this route.[104] Also in 1994, the Commission authorized state aid granted to Air France by the French government to the amount of 20 billion francs in three tranches over the 1994-96 period. This aid was part of a restructuring plan intended to enable the airline to restore its economic and financial viability by the end of 1996. The Commission made it a condition that Orly airport could be used by non-French carriers, as had been demanded by British Airways; that no transfer of aid to Air Inter would take place; that Air France's routes were to be frozen in their present pattern; and that there was to be no increase in its fleet.[105] Furthermore, the Commission insisted that the French government must not interfere in the management of Air France for other reasons than in its role as a shareholder; that the aid should be used exclusively for restructuring purposes; that the French authorities should not give Air France preferential treatment; and that the French authorities would not grant further capital or any other aid in any form to Air France.[106] The Commission authorized state aid by the Greek government to Olympic Airways for 545 billion Greek drachmas (ECU 1.9 billion) as part of a restructuring plan in 1994 on certain conditions: the Greek government undertook no longer to intervene in the management of Olympic Airways except within its strict limits as a shareholder, to confer on the airline the fiscal status of a public limited company, to grant no further aid in any form and to adopt the legislation needed for effective implementation of the social and financial aspects of the plan.[107] In this case, the Greek government managed to persuade the Commission that New York and Sydney flights should be maintained under the airline's restructuring plan, even though losses incurred on these routes were equivalent to almost two-thirds of the airline's overall operating losses. Furthermore, even though Olympic Airways was rated poorest among EC airlines on punctuality and passenger service, Greek customers proved surprisingly loyal to their national carrier. In addition, Olympic operated domestic flights to the Greek islands all the year round, even though some winter flights were half empty, and in this way made a significant contribution towards the survival of the small island communities in Greece.[108] In 1995, the Commission allowed the German government to contribute to pension funds for Lufthansa employees. This aid consisted of a financial contribution of the Federal Government of DM 1.55 billion over a period of 15 years. The German government contribution also included a guarantee designed to cover the payment of supplementary pensions, should Lufthansa ever be unable to meet its obligations. Following the recent privatisation of

103 Eaton, Jack, *op. cit.*, p. 150.
104 Commission Decision O.J. No. L 54 of 25 February 1994, p. 30.
105 Eaton, Jack, *op. cit.*, p. 150.
106 Commission Decision IP/94/699, 27 July 1994.
107 Commission Decision IP/94/700, 27 July 1994.
108 Eaton, Jack, *op. cit.*, p. 151.

Lufthansa, the airline company must - as a private company - establish a supplementary pension fund itself, which would require a capital reserve of DM 1.6 billion, putting a huge financial burden on the Lufthansa privatisation programme. This is the reason why the Commission approved of the measures adopted by the German government.[109] In 1996, the Commission allowed the Spanish state-controlled holding Teneo to make a commercial investment of 87 billion pesetas in the national airline Iberia. The airline had already received state aid of 120 billion pesetas in 1992 which was used to finance an ambitious expansion programme in Central and South America. As a condition, Iberia had to sell an important part of those assets in Latin America. Furthermore, the capital injection was to be specifically limited to redundancy payments and the reduction of excessive gearing. Iberia also pledged itself to a salary freeze in 1995 and 1996, a reduction of its employees, a planned reduction of costs, an overall reduction in the fleet and an upgrading of its software systems.[110] As Iberia had already received state aid, and the Commission's policy was to allow state aid only once, the case was difficult. Accordingly, the Commission decided that the latest capital injection in 1996 should not be treated as a state subsidy but as an investment by a public shareholder that could be justified on commercial grounds.

It has been argued that state aid, which is sometimes big enough to start a new airline, could be employed better in this way, and that state aid lessens the airline in question's incentive to improve its efficiency. In the wider context, it has been argued that liberalization of the market for air transport is a hopeless venture, because the market obstinately reflects a bilateral regime based on the nationality of airlines designated to use traffic rights. Under the prevailing bilateral system the only way to introduce an international airline is to create a new nationality out of the different nationalities of the merging airlines, as was done for SAS. Some such partnership agreements are described in the next section.

109 Commission Decision IP/95/456, 10 May 1995.
110 Commission Decision IP/96/102, 31 January 1996.

4. Airline partnership agreements and Commission control

In this chapter, three aspects of partnership agreements will be described. Practically all the European airlines have entered into partnership agreements both between themselves but also with American and Asian airline companies. These agreements vary a good deal in their content, and an overview is presented below under A. In the European Community, the Commission has two means of controlling such agreements, either by applying Article 85 or the Merger Control Regulation.[111] If an agreement falls within the area of prohibited agreements in Article 85(1), the airline company in question may apply to the Commission for an exemption under Article 85(3), which the Commission may grant or not. This is considered below under B. If an agreement falls under the Merger Regulation, it must be notified to the Commission, and the Commission will then consider if the merger or alliance is compatible with the common market or will lead to the creation of a dominant position as a result of which effective competition will be significantly impeded in the common market (see below under C.).

A. Airline partnership agreements

The objective of partnership agreements is to create competitive advantages for the partners by complementing each other's services and by achieving economies of scale, particularly in maintenance and marketing costs, while still keeping their independence. European airlines in particular favour the partnership strategy, although since 1993, American companies are also looking for alliances. Most of the agreements made between the European airlines follow a pattern set by British Airways. Agreements can take different forms including equity participation by partners in each other's companies. Usually the partner airline to an alliance brings its existing partners into the consortium and airlines can be involved in several alliances with different objectives. For instance, an airline may have a ground handling alliance with one company and a sales alliance with another. Thus, Swissair, SAS and Austrian Airlines had a commercial agreement to merge their sales, reservation and passenger services;[112] KLM has extended preferential arrangements and in some cases takes equity participation in airlines that supply its long-haul network at its Amsterdam hub. The agreement with NorthWest Airlines is an example of this. Lufthansa has made an agreement with Air France and Japan Airlines to fund a construction project for a new terminal at New York's Kennedy airport.[113] British Airways and USAir as well as KLM and NorthWest have agreed to merge their reservation services and to include code-sharing. The agreement between British Airways and USAir was substituted by an agreement between British Airways and American Airlines in 1996.

The purpose of airline alliances and agreements can usually be divided into three main categories: 1) purely commercial agreements for the purposes of joint marketing; 2) alliances for the purposes of control and the acquisition of capital interests; 3) franchising agreements.

111 Council Regulation No. EEC/4064/89 (O.J. 1989 No. L 395/1).

112 A so-called European Quality Alliance (EQA). Following Swissair's agreement with Sabena, Swissair undertook, as one of the commitments demanded by the Commission, to terminate its cooperation agreement with SAS within the EQA by 1 January 1996 (Commission Decision of 20 July 1995, IP/95/805).

113 Vellas, F. and L. Bécherel, *op. cit.*, p. 149.

The *commercial* agreements are distinguished according to whether they are tactical or strategic. The *tactical* agreements usually comprise one specific activity, such as a joint marketing programme or co-operation on a specific route (code sharing), while the *strategic* alliances cover many different activities, such as marketing, technical operations, representation and administration (code sharing) and may have long-term objectives. Alliances for the purpose of *acquisition of capital interests* were rare at the beginning of the 1990s, but some airline companies, such as Tyrolean and Air UK, were able to attract potential investors during that period. On the other hand, airlines may also want to divest themselves of capital interests in other airline companies, which was the case when Air France decided to sell its capital interests in Sabena, which it had acquired in 1992. In the meantime, 49.5 per cent of the capital in Sabena had been acquired by Swissair. But there is a general tendency towards co-operation and consolidation. All the national airline-companies in the EC have subsidiary companies or big or small capital interests in other airline companies both inside and outside Europe. This form of co-operation is based upon three different strategies. First, to obtain control over the airline's own market; examples are the mergers between Air France-Air Inter, British Airways-British Caledonian-Dan Air, Austrian Airlines-Tyrolean. Second, to establish the airline on another European market; examples are the mergers between Lufthansa-Business Air-Lauda Air on one hand and British Airways-Deutsche BA-TAT on the other. Third, to forge global alliances such as KLM-NorthWest, British Airways-American Airlines, United Airlines-Lufthansa. In some cases, the alliances are made without any intention of taking over or acquiring capital interest. The alliance between SAS, Swissair and Austrian in 1991 is an example of this. Later a more comprehensive alliance was made between SAS and Lufthansa under which the two airlines agreed to establish a joint frequent flyer programme, joint ground handling services and code sharing. Most of the alliances which do not involve the acquisition of capital interests will include code sharing. *Franchise* is a new concept in the area of air transport. As an example, five British airline companies now have a code sharing agreement with British Airways. They fly under the British Airways logo and symbols, the colours of BA are used for uniforms, cabin design, duty-free shops etc., and they share a number of services such as revenue control, the administration of frequent flyer programmes, reservation systems, etc. The participating airlines (City Flyer, Manx, G-B Airways, Loganair, Maersk) are committed to uphold the British Airways level of service, and they must pay a fee for the arrangement to British Airways.[114]

To sum up, the main alliances between airlines in Europe with airline companies both in the US and in Asia are the following: 1) Lufthansa, SAS, United Airlines, Emirates, Thai Airways, Air Canada and South African Airways. Lufthansa has several other, smaller alliances with partners both inside and outside Europe, among these partners is Finnair; 2) Air France, Continental Airlines, Delta Airlines, Britair, Alitalia and Iberia; 3) British Airways, American Airlines, Qantas, Deutsche BA, TAT and Air Russia (the three last-mentioned have been acquired by BA); 4) Delta Airlines, Sabena, Swissair and Austrian Airlines. Air Canada joined the Lufthansa alliance (1) and, as from 1 May 1997 the alliance is called the *Star Alliance*. On 1 October 1997, the alliance was joined by the Brazilian airline company Varig. The alliance

114 Commission Report of 22 October 1996 COM (96) 514 final, pp. 19-20.

is strategic and will among other things involve a pooling of the companies' FFPs. The alliance is an answer to the proposed alliance between American Airlines and British Airways, which was negotiated in 1996, described below.[115] Even though the alliances themselves are not a direct consequence of the liberalization of air transport in the EC, the third package helped to promote this type of agreement. There were 59 alliances in 1990, 138 in 1994 and 171 in 1995.[116] The question is, however, whether or not they are seen by the Commission to have anti-competitive effects. This will be described in the following two sections.

B. Airline partnership agreements and competition, Article 85 of the EC Treaty

As mentioned above in Chapter 2 D, the application of Articles 85 and 86 of the EC Treaty on air transport between airports within the Community was effected by two Council Regulations: 3975 and 3976/87 as part of the first package in 1987. The Commission has issued a number of block exemptions under Regulation 3976/87. In the Commission Communication called *The way forward for civil aviation in Europe*, published in 1994 as a follow-up to the report of the *Comité des Sages*, the Commission mentioned application of the competition rules to the air transport sector as one of its priority fields. The Commission deemed that cost-saving forms of airline co-operation could play an important role in the restructuring process of the industry. The Commission would thus examine the possibility of establishing guidelines for the application of Articles 85 and 86 of the EC Treaty for different types of inter-airline co-operation to encourage efficiency and increase different forms of co-operation. So far the Commission has not issued guidelines in this area, however.[117] In its 1996 report on air transport and the impact of liberalization, the Commission announces its intention of putting forward proposals to widen the scope of application of Regulations 3975 and 3976/87, but it has not yet made good its intention.[118]

The Commission may itself initiate proceedings against airline agreements under Article 85, but so far there are no instances of the Commission completing an investigation started on its own initiative. However, the Commission has examined a number of applications for exemption of joint operating agreements between airlines, in some cases granting exemption and in others requiring the termination of the agreement, principally because the two airlines concerned were national carriers.[119]

One of the recent decisions in this area started as a result of a notification to the Commission of 11 May 1995 of a general co-operation agreement between Lufthansa and SAS providing for the establishment of an integrated air transport system between the two airlines. The two partners requested the Commission to find that their agreement did not infringe Article 85(1)

115 The *Star Alliance* is a more successful venture than the attempt made by SAS director Jan Carlzon in 1994, called the Alcazar alliance, but which failed. It involved SAS, KLM, Swissair, Austrian Airlines, Airlines of Britain and Martinair. The alliance fell apart because the prospective partners could not agree on an American partner to operate the crucial North Atlantic network. See Vellas, F. and L. Bécherel, *op. cit.*, p. 149.

116 Commission Report of 22 October 1996 COM (96) 514 final, p. 19.

117 Commission Communication, COM (94) 218 final.

118 Commission Report of 22 October 1996 COM (96) 514 final, p. 23.

119 Balfour, J., *op. cit.*, p. 1035.

of the Treaty or, alternatively, that the conditions were met for granting exemption under Article 85(3). The alliance was intended to establish an integrated transport system based on a comprehensive set of long-term commercial, marketing and operational relationships and involving integration of their worldwide networks and other operations.[120] The Commission decided first of all that the agreement was a joint venture. The Commission next considered that the co-operation between Lufthansa and SAS was likely to increase the two airlines' economic power substantially. At the time when the notification was submitted, British Airways in terms of fleet size was in first place in Europe, Lufthansa second and SAS third - ahead of Air France.[121] The agreement would restrict potential competition not only between the two partners but also *vis-à-vis* third parties. The agreement was also likely to increase the two airlines' economic power resulting from the co-ordination of their resources, the availability of the largest European fleet, the scope for interlining, the co-ordination of networks and the co-ordination of frequencies. The Commission took the pooling of the two airline companies' FFPs into account in assessing their economic power. Most of the customers were businessmen and they would clearly prefer airlines to have joint FFPs allowing them to earn points whichever airline they used. A common system was thus likely to constitute *a not inconsiderable entry barrier to other airlines that did not have comparable programmes* - as the Commission put it. Consequently, the Commission considered that the co-operation agreement between Lufthansa and SAS had as its object and effect the restriction of competition in breach of Article 85(1). However, the Commission found that both Lufthansa and SAS differed from British Airways and Air France in having a higher proportion of intra-European routes and being correspondingly weaker on extra-European routes, SAS figuring largely on intra-Scandinavian routes and being thus far more regionally biased. In the light of these factors, the Commission found that the two networks of Lufthansa and SAS, respectively, were complimentary and that the pooling of the two networks would make it possible to improve the services rendered to consumers. In the light of this and other factors, the Commission was of the opinion that the agreement was likely to contribute to economic progress within the meaning of Article 85(3), and that the restriction of competition was necessary as the market stood. The Commission granted an exemption on this basis under Article 6 of Regulation 3975/87 for a period of ten years until 31 December 2005, subject to certain conditions and obligations such as freezing the number of frequencies on certain routes, and allowing new entrants to serve on that route. As the Commission thought that the pooling by Lufthansa and SAS of their FFPs was likely to be a not inconsiderable barrier to market entry, the Commission also made it a condition that any other airline which provided or wished to provide services on the routes in question, and which did not have a frequent flyer programme applicable at international level, must be afforded the opportunity of participating

120 The main features of the alliance were the setting-up of a joint venture for traffic between Germany and Scandinavia, worldwide co-operation involving joint network planning, a joint pricing policy and joint budgeting, including reciprocal access to frequent flyer credits, code-sharing, harmonization of service levels and integration of data processing, a single marketing strategy and the organization of a hub system.

121 When the agreement was signed, Lufthansa and SAS were the only airlines operating eight routes with daily frequencies between Germany and Scandinavia, except for one frequency per day between Frankfurt and Copenhagen operated by Singapore Airlines. In terms of the number of passengers carried, these eight routes accounted for 66 per cent of all traffic between Scandinavia and Germany. The new entity would thus operate on 20 of the 25 routes between Scandinavia and Germany.

in the programme operated by Lufthansa and SAS. Lufthansa and SAS were also required to give up a number of slots to new entrants.[122]

In October 1996, the Commission started formal proceedings on the basis of a notification from the involved airlines of 11 June 1996 to look at an agreement between British Airways and American Airlines, primarily intended as a code-sharing alliance. The alliance replaced the former agreement between British Airways and USAir. The new alliance was intended to become effective only if a bilateral agreement between the US and UK governments was signed to liberalize flights between the two countries. This *open skies* agreement was subject to lengthy transatlantic negotiations.[123] The alliance was clearly of interest to the UK government. The US government, on the other hand, maintained that it would only grant approval if the UK government agreed to the open-skies treaty.[124]

In the Commission's official notice of proceedings, the Commission announced its intention of examining the compatibility with Community competition rules of the AA-BA agreement. It was evident that, even though the agreement was made between only one member state and the US, it was assumed to have far-reaching consequences for air transport in the internal market. It would in fact be a global alliance. It involved code-sharing and joint marketing on the North Atlantic alliance services and the partners entered into a worldwide, fully reciprocal frequent flyer arrangement. In the official notice, the Commission invited member states and all interested parties to submit any comments they might have on the notified agreement. The Commission has not yet formally approved the agreement. In July 1998, the Commission adopted its preliminary position on the BA-AA alliance. The Commission intends to approve the alliance provided certain conditions are fulfilled. But without the proposed conditions, the implementation of the alliance will - in the Commission's opinion - amount to an abuse of the parties' dominant position on hub-to-hub routes, contrary to Article 86 of the Treaty. The Commission also considered that the AA-BA agreement would restrict competition contrary to Article 85. Among the conditions which will be imposed for the alliance to be approved, is one

122 Commission Decision of 16 January 1996 96/180/EC which came into operation on 26 January 1996.

123 *The European*, 16-22 January 1997, pp. 1 and 17. According to the *New York Times* of 12 June 1997, the European Commission was expected to rule on the transatlantic alliance between British Airways and American Airlines well before November 1997, as BA had threatened to abandon the alliance with AA if it did not receive regulatory approval by November. The Competition Commissioner, Karel van Miert said to the *New York Times* that it would be at least September before he finished his antitrust review. The open skies policy of the US intends to trade greater access to its mighty home market for liberal bilateral air treaties with as many takers as it can find. These bilateral open skies treaties allow airlines from the two signatory states the freedom to operate where and when they want and charge whatever fares they wish. The US follows its policy of picking off individual countries, which is easy enough in a European Community which remains disunited (see Part I, chapter 1B).

124 As a result of the difficulties which the Commission experienced with the British government, it has also opened retroactive investigations into all the existing alliances between European and American airline companies, notably the alliances between Delta Airlines of the US, Sabena, Swissair and Austrian Airlines and between Lufthansa, United Airlines and SAS as well as the alliance between KLM and NorthWest Airlines. See *The European*, 16-22 January 1997, p. 17. The proceedings concerning the Delta, Sabena, Swissair and Austrian airlines agreement are described above in the text.

relating to frequent flyer programmes. Full details of the proposed conditions will be published in the EC's Official Journal, giving interested parties thirty days to comment.[125]

At the same time, the Commission started - on its own initiative - retroactive investigations into the co-operation agreements concluded between Delta Air Lines, Sabena, Swissair and Austrian Airlines and the compatibility of these agreements with Article 85 of the Treaty. The agreements consisted of three separate and parallel co-operation agreements between Delta and each of the involved European carriers and a co-ordination agreement among the four carriers covering the co-ordination of the three co-operation agreements. By entering into the alliance, the main goal of the air carriers concerned was to form a multi-hub network across the Atlantic by linking the US and European hubs of all four parties in order to compete effectively with other global transnational alliances. It was the intention of the parties to expand their existing co-operative marketing relationships and create a seamless air transport system, while retaining their separate corporate and national identities. There were two co-operation programmes in the agreement, one for passengers and one for cargo. The passenger programme covered marketing and sales programmes, co-ordinated schedules, shared revenues/earnings, co-ordinated pricing and inventory control, co-ordinated commission programmes, joint use of data and information systems, joint advertising/media programmes. The Commission had not at the stage when it gave notice taken a position as to the applicability of Article 85 of the Treaty.[126]

C. Airline take-overs, mergers and concentrations

The Merger Regulation imposes a duty on merging companies of a certain size to notify the Commission of the agreement - often termed *concentration*. The Commission then considers if the merger is compatible with the common market or will lead to the creation of a dominant position for the merging companies as a result of which effective competition will be significantly impeded in the common market.[127]

Before the coming into operation of the Merger Regulation, the Commission was quite active in monitoring concentrations between airlines. The first case in which it intervened was in 1986 when British Airways acquired British Caledonian, and over the subsequent years it similarly investigated the acquisition of UTA by Air France and the increase by KLM of its shareholding in Transvia. In each case, the Commission reached a settlement with the parties whereby the Commission permitted the acquisition to proceed, but on the basis of certain undertakings and conditions designed to preserve and foster competition. The legal basis on which the Commission did this was unclear, but it can only have been under Articles 85 and 86 of the Treaty.[128]

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125 Commission Notice O.J. No. C 289 of 2 October 1996, p. 4. At the same time that the Commission published its preliminary position on the BA-AA alliance, it also adopted an identical preliminary position on the transatlantic alliance between Lufthansa, SAS and United Airlines. Commission Communications IP/98/640 and IP/98/641 8 July 1998.

126 Commission Notice O.J. No. C 289 of 2 October 1996, p. 6.

127 Council Regulation No. EEC/4064/89 (O.J. 1989 No L 395/1).

128 Balfour, J., *op. cit.*, p. 1037.

Since the coming into operation of the Merger Regulation, the Commission has examined five cases of concentrations between airlines: Delta and Pan Am in 1991, Air France and Sabena in 1992, British Airways and TAT also in 1992, British Airways and Dan Air in 1993 and Swissair and Sabena in 1995.

The Delta-PanAm case was remarkable in being a concentration between two non-EC airlines, but the necessary Community-wide turnover existed to subject the concentration to the scope of application of the Merger Regulation.[129] However, the Commission concluded that it would have no appreciable effect on competition, principally because of the highly competitive nature of the transatlantic air service market. In the Air France-Sabena concentration, because of the geographical proximity of Paris and Brussels airports, there was a much greater potential effect on competition, but the Commission secured conditions and undertakings designed to create opportunities for competition on the routes on which the two airlines competed, namely the Brussels/Paris route, routes to Hungary and Turkey and long-haul routes to Africa. Air France decided to sell its capital interests in Sabena. The Commission took a similar approach to the overlapping markets in the British Airways-TAT case, although there were very few routes on which the two airlines competed.[130] BA and TAT undertook - among other obligations - to offer to those competitors on the Gatwick-Paris route who did not themselves participate in an FFP the opportunity to participate in their FFP under reasonable and nondiscriminatory financial conditions, if they so requested. It was to be understood that such a commitment would terminate when Community regulations concerning FFPs were adopted. The British Airways-Dan Air case was unusual, because, although the Commission found that the turnover of that part of Dan Air's business acquired by British Airways did not meet the required 250 million ECU-threshold, Belgium subsequently exercised its rights under Article 22(3) of the Regulation to ask the Commission to examine the specific effects of the concentration on the Belgian market. In view of the highly competitive nature of the London-Brussels market, the Commission found - understandably - no appreciable effect on competition.[131] In the Sabena-

129 Delta and the part of PanAm that was purchased achieved a Community-wide turnover exceeding the 250 million ECU required by the Regulation. After the concentration, the parties accounted for about 16 per cent of the overall US/Western Europe scheduled air transport traffic, but the combined market share of the parties after the concentration would not exceed 25 per cent. Although Delta would be a carrier with a high market share after the concentration, it would still be exposed to a large number of competitors with significant presence in the overall transatlantic air traffic, primarily American Airlines, British Airways and TWA. On this background, the Commission found that effective competition would not be significantly impeded in the common market or a substantial part of it. Therefore, applying Article 6(1)(b) of the Merger Regulation, the Commission did not oppose the notified concentration (Commission Decision of 13 September 1991 O.J. C 289, 7 November 1991).

130 As in the Delta-PanAm case both BA and TAT attained a Community-wide turnover of more than 250 million ECU in 1991. At that time BA was not present at all on the French domestic routes where TAT accounted for 3.8 per cent of the overall scheduled traffic. The main airline operating in this market was by far Air France with an 84.9 per cent share of the overall number of passengers transported on domestic routes. Consequently, the concentration did not lead to any overlap with respect to TAT's domestic routes, its effect being that BA would have limited access to the French domestic network (this was before the third package) and certain possibilities to feed its international operations from France. (Commission Decision of 11 December 1992 O.J. C 326 11 December 1992). Air France sued the Commission in the European Court of First Instance under Article 173 of the Treaty but its action was rejected (case T-2/93).

131 Commission decision O.J. 1992 C 328/4.

Swissair case, Sabena and the Belgian state would transfer 49.5 per cent of Sabena's shares to Swissair. The remaining 50.5 per cent would be held by the Belgian state and by Belgian institutional investors. The combination of the parties' networks would lead to a monopoly with regard to air transport between Switzerland and Belgium. On the wider European level, on the other hand, the combined share of Swissair and Sabena was relatively small. At this time, the Commission was also examining the Lufthansa-SAS alliance under Article 85. Furthermore, Swissair, SAS and Austrian Airlines already participated in a European Quality Alliance (EQA).[132] The Commission found that the existence of the three alliances, namely the alliance between Sabena and Swissair, the EQA and the Lufthansa-SAS co-operation agreement would enable the participating airlines to establish an extensive integrated European network. Together these airlines would account for approximately 35 per cent of passenger traffic within Europe and would carry in Europe more than twice as many passengers as the next-largest carrier. Therefore, the Commission had serious doubts as to the Sabena-Swissair alliance's compatibility with the common market. However, Swissair and Sabena undertook commitments and the Swiss and Belgian governments made declarations which removed the Commission's doubts. One of these commitments was an undertaking by the two airlines to allow other, competing carriers to participate in their FFPs. Thus Swissair and Sabena would offer to new entrants who did not already participate in an FFP the possibility to participate in their FFP. For this and for other reasons specified, such as making slots available, no increase of frequencies without prior notice and the conclusion of five year inter-airline agreements with new entrants, the Commission allowed the concentration.[133]

Conclusion to Part II

Frequent flyer programmes are only one pawn in the very big chess game of air transport. There are very special features which characterize air transport and make it an industry which can be compared to no other except perhaps space travel. There is still an aura of discovery surrounding air transport, which may be compared to that of the former explorers of the two Poles, the mountain climbers of the Himalayas or the first space voyagers to land on the moon. The national flag plays a significant role in all these contexts, and it is no coincidence that the national airlines are called *national flag carriers* - even after privatization. Not only is air transport a recent invention, but it also involves technology at a very high level, huge investments and deep-seated national interests. The trend both in North America and in Europe has been to get away from all this. Deregulation and liberalization, application of the competition rules, privatization and the prohibition of state aid together are proof that governments in both the US and Europe want to make air transport an industry subject to ordinary market conditions.

In the US in the early 1990s the government did not interfere when - as a result of deregulation and the introduction of free competition - famous names such as PanAmerican disappeared, nor when US domestic carriers were operating under America's Chapter 11 bankruptcy

132 EQAs are also referred to in footnote 112.
133 Commission Decision of 20 July 1995, IP/95/805.

regulations, which permit an airline to continue to operate although officially bankrupt, while restructuring its finances. The outcome in the US was not the one which had been expected. The US government had expected that inefficient large carriers would be undercut by smaller airlines with lower overheads and higher productivity. The opening years of deregulation did in fact see a rapid expansion of airline operations with a threefold increase in new airlines. But within a decade of deregulation more than a hundred airlines, including two out of three of the newly launched airlines, were forced out of business or absorbed as fares became more competitive and profit changed to losses. In the long term, what occurred was the growth of a handful of huge so-called *mega-carriers*. Christopher Holloway describes the situation in the US as follows:

> *By the end of 1991, a total of some 200 carriers had disappeared, leaving the field to fewer than 10 major airlines, of which the "big three" - Delta, American and United - had the lion's share of the air travel market. Far from expanding opportunity, deregulation had led to small airlines being squeezed out, or restricted to less important routes, by the marketing power of the big carriers*[134]

It is in this context that frequent flyer programmes have become a more important factor than they might otherwise have been. The big American carriers which survived deregulation were the first to introduce FFPs, and they became so popular that no airline in the US could survive without having one; before long they were also introduced on the European airline market.

The European approach to air transport liberalization has been more cautious, as is evident from the flexible approach adopted by the European Commission in the cases involving airline alliances, state aid and merger control described above. Privatization of the national airline companies has also proved to be a very slow and difficult process, and only one European airline, namely British Airways, is operating as a fully commercial company, though KLM comes close too. In contrast to the US, no national airline in Europe has been allowed to go bankrupt. On the contrary, the grant of state aid has been allowed by the Commission to airlines experiencing financial difficulties. To a considerable extent, the European market remains a monopoly or a duopoly in the sense that routes between two national airports in the Community remain dominated by one or two national carriers, which have formed alliances approved by the Commission. New and smaller airline companies have found it difficult to gain access to the market and offer competition with cheaper flights between such destinations. At no stage has the European programme of liberalization been able to proceed at the same pace as the American programme of deregulation, thanks to the different positions of the member states in the European Community towards liberalization and to obstacles presented by technical, administrative and language barriers. The overall impression is that, once the European airline companies were allowed to compete on a common market under normal market conditions and with less government control, they adopted procedures, such as seeking alliances with other airline companies, to increase their powers on the market. Mergers and

134 Holloway, J.C., *op. cit.*, p. 80.

take-overs of the smaller, competing airlines were another aspect of this, such as British Airways' acquisition of British Caledonian, Dan Air and of capital interests in Deutsche BA, Air Russia and TAT, not to mention Air France's acquisition of UTA and Air Inter and KLM's of Transavia. Some of these alliances, mergers and take-overs were found by the Commission to show anticompetitive aspects, but were permitted notwithstanding, at least for a certain limited period of time, because they contained elements which benefitted consumers at least in the short run. New entrant airline companies found it very difficult to obtain *slots* in the national airports. In fact the recent increase in air traffic has lead to an increasing shortage of slots at major airports in the Community. It has proved a crucial factor in the liberalization process, and a Council Regulation deals with this question exclusively.[135] As most of the European airports are rapidly approaching a saturation point in terms of the number of aircraft movements that can be handled within a given time, it proved a near impossibility for new entrant airlines to launch new services to or from a congested airport, and hence on most of the major routes in the Community. Slot allocation therefore figures largely in the Commission's deliberations, when considering new airline alliances, and a duty for the partners to give up slots at their national airports to new entrant airlines was imposed on the alliance partners. From this angle the question of frequent flyer programmes and their possible anticompetitive effects may seem less important, though an Economist Intelligence Unit report on international business travel of 1994 identifies FFPs as being *the* most important travel policy issue facing companies whose employees travel on business.[136] Nevertheless, the questions of whether or not they have anticompetitive effects, whether or not they represent an undesirable marketing practice and, therefore, whether or not they should be regulated, remain open and are gaining increasing importance as the liberalization process gathers momentum in the Community. In Part III, the development and effects of FFPs will be described, and a case for regulating them will be presented.

135 Slots are defined as times allocated to airlines at airports during which they may use the runway for take-off and landing. Council Regulation No. EEC/ 95/93 O.J. 1993 L 141, p. 1.

136 Rowe, Irene Vlitos, *International business travel - a changing Profile*, an EIU research report of 1994, p. 184.

Part III. The historical development of frequent flyer programmes

When frequent flyer programmes are discussed in an academic context, the proposals for their being ended or at least regulated will often be met by the following argument: *Frequent flyer programmes are really a tiny pawn in the large chess game of air transport, not at all comparable to the really big issues such as mergers and consolidations of airline companies, slot control and ground handling services in airports, computer reservation systems, etc.* Nevertheless, their importance should not be underestimated. Michael E. Levine, writing about airline competition in deregulated markets, makes this comment on the significance of FFPs:

> *Frequent flyer programs have assumed an unexpected importance in deregulated airline competition. When first introduced by American Airlines in 1980, the frequent flyer program seemed to many observers in and outside the airline industry, and perhaps to American itself, to be a marketing "gimmick" of only peripheral importance. It is now apparent that frequent flyer programs are very important keys to competitive viability. They have been adopted by virtually every carrier of any size. Even airlines whose hub systems give them relatively large proportions of monopoly routes, like Piedmont and USAir, have been forced to offer them after initial resistance, as have new entrants such as People Express, America West, and Midway, which had expected that their low and relatively non-discriminatory fare structures would make bonuses unnecessary.*[137]

In this section the development of FFPs will be considered as it first took place in the US and later in Europe. In this connection, some attempts to regulate them in the US (A), in the European Community (B) and in the Nordic countries (C) will be described, and some concluding remarks on the whole development of FFPs will be made (D).

A. FFPs in the US

The US Airline Deregulation Act of 1978 was signed by President Jimmy Carter and came into operation on 1 January 1979. The Act enforced a gradual relaxation of the domestic regulation of the American air transport industry, which until then had rested with the Civil Aeronautics Board. The Board's authority over routes ended on 31 December 1981, over fares on 1 January 1983 and its authority over domestic mergers and alliances was transferred to the Department of Justice on 1 January 1983. The Board ceased operations entirely on 1 January 1985. Among other things, the Act provided for a limited degree of automatic market entry, it relaxed the necessity to prove that entry was required by public convenience and it set a zone

137 Levine, Michael E., Airline Competition in Deregulated Markets: Theory, Firm Strategy and Public Policy in *Yale Journal on Regulation*, Vol. 4, 1987, p. 414.

for reasonable fares within which airlines could vary fares without first seeking permission to do so.[138] Initially, the market reacted just as expected by the deregulation proponents. New airlines entered the market offering lower fares and better services. But even though the new entrants had lower operating costs than their huge competitors, they quickly found themselves in trouble. The established airlines - at that period Pan American (PanAm), Trans World Airlines (TWA) as well as Delta Airlines, American Airlines (AA), United Airlines (UA), Continental Airlines, Eastern Airlines, USAir and Western Airlines - were swift in finding new marketing strategies which saved them in the new competitive situation. The main strategies were development of hub and spoke route networks, computer reservation systems (CRSs), frequent flyer programmes and, perhaps most decisive of all, their continued control over landing and take-off slots at airports.[139] As a result of the success of these strategies as well as of loss-incurring price wars, financial instability and inadequate profitability cleared the skies of the new entrants and their lower fares. Eventually, most of the new entrants went bankrupt or merged with the established airlines and many of the US major airports became dominated by one or two airlines.[140] Between 1979 and 1985, 18 new airline companies had entered the market. By 1991, 11 of these were bankrupt and another four acquired by bigger competitors. Quite a few of the big airlines also experienced financial problems, but managed to survive. Deregulation effectively led to a heavy concentration in the industry, strictly contrary to what was expected less than a decade earlier.[141]

One of the determinant factors in the battle for airline survival in the early years of deregulation was the development of the *computer reservation system (CRS)*. CRSs are described by Auliana Poon as follows:

> *A computerized reservation system consists of "a periodically updated central database that is accessed by subscribers through computer terminals" … CRSs provide subscribers with up-to-date information on air fares and services and permit users to book, change and cancel reservations and to issue tickets. Travel agencies are the main subscribers to CRSs while airlines are the owners, developers, hosts or vendors of the American CRSs. While CRSs were designed primarily to provide travel agents with information on airline services, they now display information for a range*

138 Bailey, E.E. et al., *Deregulating the Airlines*, MIT Press, Cambridge, Mass, 1985, p. 34. The consequences of deregulation and the abolition of the Civil Aeronautics Board for US international regulation of air transport are described in Part II, Chapter 1 B.

139 As multiple route designation became allowed, the established airlines developed the strategy of no longer flying direct between cities, but instead flying their passengers from far-off destinations (*spokes*) to one of the operating bases (*hubs*) of the airline. From this hub, the long-haul and transcontinental services were fed. This led to better utilization of aircraft and flight crews and higher load factors, but of course also to some inconvenience for the airlines' customers. Drabbe, Humbert, EC competition director, has said: *The FFP is only one of the modern commercial management tools used in the aviation sector, other examples are the CRS, yield management, franchising and creation of hubs*. See Verchère, Ian, Airlines Frequent Flyer Programmes: Counting the Cost of Loyalty in *Executive Travel*, February 1997, p. 31.

140 Verchère, Ian, Frequent Flyer Programmes (FFPs) in *Travel & Tourism Analyst*, No. 3, 1993, p. 11.

141 Dempsey, P.S. and A.R. Goetz, *Airline deregulation and laissez-faire mythology*, Quorum Books, Westport, CT, 1992, p. 236.

of travel and leisure services and permit reservations to be made for hotels, car rentals, cruises, railways, tours, boat charters, theatre and sporting events, as well as issue travellers cheques, exchange currency, validate credit cards, write insurance policies and order flowers ... CRSs also store and retrieve information on consumers - their airline, ticket class, seating and dietary preferences as well as their addresses, telephone, credit-card numbers and buying patterns of related services (e.g. travellers cheques, insurance). CRSs also store and retrieve information on airlines and other suppliers' services, such as hotels and car rental companies that distribute their services through CRSs.[142]

Computer reservation systems can be divided into three categories: 1) the GDS which is a global distribution system covering different countries in the world. In many cases, a GDS is actually owned by several airlines, each of whom has their own CRS; 2) the CRS described above; 3) the LDS which is a local distribution system, i.e. a national or regional version of the CRS offering the same services but on local or regional level. Both GDSs and LDSs are used for flight reservations but may also include other services such as hotel reservations and car rentals. There are four GDSs in the world today: Amadeus/System One, Galileo/Apollo, Sabre and Worldspan. An example of an LDS is Smart, which is owned by SAS and covers Scandinavia.[143]

The first semi-mechanical reservation systems were installed just after World War II as simple storage guidance systems. A chance meeting between an official from American Airlines (AA) and an official from IBM led to the formation in 1959 of Sabre, Semi-Automated Business Research Environment.[144] The other airlines followed suit in the late 1960s, United Airlines with Apollo and Trans World Airlines with PARS, which in 1976 installed their first CRS terminals in travel agents' offices throughout the USA. System One was founded by Continental Airlines in 1991. Delta Airlines' DATAS II installed their first terminals with travel agents in 1982, also in the USA. DATAS II and PARS were joined together in 1990 forming World Span Travel Information Services. Originally, the CRS systems only covered the flight plan of the owners, but in 1987 Sabre, and soon after Apollo, began to offer to other airline companies the chance to have their flight plans and reservations included in the CRS against payment of a fee. This was marketed throughout the whole travel industry. To begin with, the CRSs were biased, e.g. by showing their owners' own routes and departures first on

142 Poon, Auliana, *Tourism, Technology and Competitive Strategies*, CAB International, Wallingford, 1993, p. 180.

143 Marcussen, Carl Henrik, *Turistinformations- og bookingsystemer - en casesamling (Tourist Information and Booking Systems - a casebook)*, Research Centre Bornholm, 1996, p. 107. See also Inkpen, Gary, *Information Technology for Travel and Tourism*, Pitman Publishing, London, 1994, p. 78.

144 Hopper, Max D., senior vice president for information systems at American Airlines, describes the introduction of Sabre in his article: Rattling SABRE - New Ways to Compete on Information in *Harvard Business Review*, May-June 1990, pp. 118-125.

the screen.[145] This conferred an advantage on the owners, as travel agents had a tendency to choose the first option shown, namely that of the owners. At the beginning of the 1980s, this bias was removed as a result of a series of court judgments.[146] In 1984, the US Civil Aeronautics Board implemented rules to redress display bias, discriminatory booking fees, denial to participating carriers of access to marketing data and restrictive travel agency contracts. However, some anticompetitive practices still existed and the post-regulation period up to 1990 witnessed a series of private litigations and a renewed look at regulation. In May 1991, the US Department of Transportation issued proposals for new rules opening doors for multi-CRS access, allowing agencies to use one terminal for access to more than one or all the CRSs and to facilitate the use of third-party equipment and software in conjunction with CRSs. A revision of the CRS rules was carried out in October 1992 in the form of a code of practice aimed at eliminating anticompetitive practices and to ensure that CRSs were unbiased.[147] On the whole, deregulation of the market for air transport led to considerable growth of the CRS market in the 1970s and 80s, and the market increased tenfold in the US during this period. The five big reservation systems have since been reorganized as independent limited companies and sold.[148] The future of the CRSs is perhaps uncertain as airline companies such as United Airlines begin to make use of the Internet/WWW, offering services directly to individual buyers. This may have the consequence that travel agents and GDSs/CRSs become superfluous, unless of course they themselves start making use of the Internet/WWW, so that the individual buyer may book his/her ticket on the Internet, but the ticket will be issued by a travel agent. However, there are still security problems in connection with payment by payment cards which have not been solved. It will probably only be a question of time before this happens.[149]

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145 If the CRS is biased, the display will show the flights of the host airline first and all those of its competitors next, or even on a separate screen, so that if the agent wants to view these, an additional entry must be made. The flights further down the list will not be looked at so frequently, and the travel agent's choice will be biased in favour of the host airline, see Gary Inkpen, *op. cit.*, pp. 89-90.

146 Marcussen, Carl Henrik, *op. cit.*, p. 110. Hørlück, Jens, *Efter EDI: Elektroniske hierarkier, elektroniske markeder, eller? (After Electronic Data Interchange: Electronic Hierarchies, Electronic Markets, or .. ?)*, Department of Management, University of Aarhus, 1995, pp. 25-26.

147 Poon, Auliana, *op. cit.*, pp. 189-190. See also Inkpen, Gary, *op. cit.*, p. 90. Multi-access CRSs are described in Inkpen, Gary, *op. cit.*, p. 84 and p. 86.

148 Hørlück, Jens, *op. cit.*, p. 26. He gives figures for the market shares of the five biggest companies as regards sold flight tickets in the OECD in 1991: Apollo & Sabre: 31.7 per cent; Sabre: 28.2 per cent; World Span: 13.6 per cent; System One: 10.4 per cent; Amadeus: 10.3 per cent; a total of 94.2 per cent.

149 Marcussen, Carl Henrik, *op. cit.*, pp. 125-126. Apart from the Internet, there are other types of self-booking systems coming on to the market in the form of software which stores basic information on the computer hard disk of the individual buyer and allows the buyer online access to a database to view availability and to book; there are so-called robotics systems through which the buyer sends a request by e-mail via a travel agency to a CRS, views the options on-screen, and the agency then picks up the booking and does the ticketing. More than 150 airlines offer real-time schedule information and booking capability via e-mail, either direct or through the airline CRS. United Airlines' Connection software gives direct access to the Apollo CRS, allowing users to book flights with 380 airlines, 30,000 hotels and 50 car rental companies, see Churchill, David, *Airline Route Deals: Lethal Weapon* in *Business Travel World*, November 1996, pp. 58-59. The proceedings of the annual ENTER International Conference on CRSs held in Istanbul in January 1998 have been published as *Information and Communication Technologies in Tourism 1998* (ISBN 3-211-83088-X). There are hundreds of references at the end of each of the papers reiterated in the proceedings, should up-to-date information be sought. This study does not aim to cover the area of CRSs except in so far as policies for CRSs impinge on policies for frequent flyer programmes.

The fact that passengers in the US had to suffer the inconvenience of travelling to the hubs of their chosen airline, before they could embark on the flight to their final destination, was a significant factor in the development of *frequent flyer programmes (FFPs)* in the US. To compensate passengers for this inconvenience, AA first took steps to introduce a preliminary programme of club membership at the beginning of the 1980s.[150] This later became known as the AAdvantage Travel Awards Programme and was credited with being the first real airline FFP in the world. The initial step was taken by AA's sales team with the help of the AA Sabre CRS which was able to identify passengers who flew regularly with AA. George Williams describes the development as follows:

> *The first frequent flyer programme was introduced by American Airlines in 1982 and provided travellers with a reward for continuing to make use of the company's services... The primary aim was to attract passengers travelling frequently on business who, given that their companies were footing the bill, usually had no personal incentive to economize on air travel. A strong vested interest existed for such customers both to trade up and to undertake more journeys than would be strictly warranted. As a consequence, such travellers were highly important to airlines as they generated a disproportionately large amount of revenue. In 1990, for example, if frequent flyers are defined as individuals taking more than twelve airline trips annually, then approximately 3 per cent of US passengers accounted for 27 per cent of all trips and 40 per cent of airline revenues*[151]

These *frequent flyers* were automatically registered in the *Very Important Travellers Club*, a mailing list in which those on the list were provided with recognition baggage labels, better inflight food and an optional but very popular seafood menu. Having created this powerful mailing list, AA's sales department began focussing on other ways of attracting and rewarding the airline's frequent flyers. Before long they had identified the one gift which the airline had in abundance: free air travel. Based on this idea, AA instituted a promotion that turned out to be the model for all future programmes. This promotion offered to members the opportunity of accumulating mileage redeemable for specific rewards. AA decided to offer Hawaii as its reward for customer loyalty, and Hawaii remains AA's most popular destination for free award travel. Upgrades from economy to first class were a refinement on the scheme. The upgrade

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150 Prior to deregulation, carriers attempting to offer free flights would have been in serious violation of US anti-trust laws. The precursor to AA's programme was a reward concept developed by United Airlines in 1979 immediately after deregulation. To win back business lost during a damaging strike by engineers, UA started issuing passengers with $100 credit vouchers towards the cost of a future ticket on its network. Western Airlines took the idea a stage further by offering $50 discounts to passengers who flew on five flights between specified cities. Thus the Western programme was the first that was aimed at developing consumer loyalty over a period of time, as opposed to rewarding one-time purchases. Western had to stop the programme because of administrative difficulties (primarily theft, forgery and fraud). Kearney, Terrence J., Frequent flyer programmes: a failure in competitive strategy, with lessons for management in *The Journal of Consumer Marketing*, Vol. 7, No. 1, Winter 1990, p. 32. Ian Verchère, *op. cit.* 1993, p. 6.

151 Williams, George, The Airline Industry and the Impact of Deregulation, Ashgate, Cambridge, Mass, 1993, p. 38.

aimed to create a more attainable prize and, in the process, to engender support and enthusiasm for the FFP idea.[152] Ian Verchère makes this comment about AA's scheme:

> *As the goal of any commercial flight is to maximise revenue yield and load, American's idea was to use the AAdvantage FFP both to attract passengers for whom Dallas (or any of its other centres) was a logical hub and, more significantly, to attract those for whom it was not, ie to capture the traffic of other airlines. The art of poaching traffic - a well-developed and highly political issue in the world of air transport - was about to acquire a new and innovative dimension. The key was not only to reward passengers who found the hub naturally convenient but also to reward those prepared to accept some measure of inconvenience in exchange for the promise of future awards. In a business where an empty aircraft seat flown on a scheduled flight represents irredeemable revenue, transforming these wasted assets into a marketing tool for rewarding passenger loyalty proved irresistible to the airline culture. For the consumer, it tapped the same instincts that induce people to save money or buy lottery tickets. Before long it would become an obsession with millions of US and, increasingly, non-US air travellers*[153]

At the outset, AA invited some 200,000 travellers to join its FFP club, and those who flew 50,000 miles over a one-year period were given a free round trip ticket to Hawaii. Shortly after the AAdvantage launch at the beginning of the 1980s, United Airlines introduced their Mileage Plus plan which, among other things, offered a first class upgrade for 10,000 accumulated miles, and soon AA's FFP initiative was being matched by a plethora of similar plans throughout the US market. Some FFPs like that of TWA had the added benefit of offering Europe as an award destination. AA, which at that time offered only limited transatlantic services, met this challenge by recruiting British Airways to its AAdvantage programme, thus pioneering alliances with non-US carriers and compensating for network weaknesses. FFPs came to have a considerable influence on the public's travelling habits. For example, many passengers, including business travellers, began to avoid non-stop flights and instead made circuitous connections via out-of-the-way airport hubs so as to accumulate extra mileage. When travelling across the Atlantic on a non-US carrier, many passengers would select an airline affiliated to their domestic FFP. Other developments followed: Continental's *Flight Bank Programme* awarded bonus points for travel booked with a Carte Blanche credit card. This was the first of many extra ways of earning more air miles. Other ways of earning extra mileage credits were soon added: credits were given when customers bought other

152 Mason, G. and N. Barker, *op. cit.*, p. 219.
153 Verchère, Ian, *op. cit.* 1993, p. 7.

services than air travel, such as car rental, package holidays or hotel stays, long-distance telephone calls and airline affiliated credit card purchases.[154]

The battle for FFP membership thus became a vital part of any US carrier's basic marketing strategy and over the past decade the growth of frequent flyer benefits in the US has come close to saturation. A worrying factor in this development was the potential of the schemes to accumulate substantial quantities of unredeemed miles. Ian Verchère makes this comment:

> *Towards the end of its life, PanAmerican's FFP, World Pass, is said to have built up enough unused benefits to keep the ailing airline flying for a month. In the worst case, were all FFP members to redeem their miles at once, the fear existed that an airline could be propelled into bankruptcy, rather like the run on a bank where all depositors rush to withdraw their money at the same time. To prevent this happening, most airlines have begun to change the rules and limit the days on which FFP members can cash in their chips. Treble mileage, for example, vanished overnight and the earning of international benefits became tougher. Similarly, certain peak travel periods and holidays were taken out of FFPs altogether in order to avoid having to turn away fare-paying passengers to satisfy FFP obligations. Through better use of their CRSs, airlines have begun to manage their individual flight yields better and, in the process, have placed limits on the volume of FFP liability allowable. Others have introduced expiry dates on mileage in order to eliminate any FFP overhang which might further weaken already troubled airline balance sheets*[155]

By the end of 1986, 24 of 27 major carriers participated in such programmes. The net effect was to diminish the effect of the programmes in attracting customers. While increased customer loyalty allowed each carrier to hold on to its own programme members, the same process made it more difficult for carriers to attract passengers from competing airlines. However, programmes tended to be more successful for the carriers with the biggest route systems, which meant that travellers remained loyal to a dominant carrier.[156] In the middle 1980s, the level of competition between airlines decreased accordingly. Eight major carriers held a combined market share of about 93 per cent. At the individual city-pair market, few

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154 When the customer used the airline affiliated credit card, he/she would accrue mileage credits according to the volume of transactions made with the particular card. The current membership guide of the AAdvantage programme lists over 2000 restaurants in which three air miles are awarded for every dollar spent. A US pharmaceutical company used American's FFP to offer doctors a free round trip ticket for every 50 prescriptions of the firm's beta-block medication written. In USAir's programme, undertakers were offered a free return trip for every thirty bodies shipped with the airline. Mason, G. and N. Barker, *op. cit.*, p. 221.

155 Verchère, Ian, *op. cit.* 1993, p. 10.

156 Passengers are far more likely to join a major airline's FFP than one offered by a smaller carrier, because the larger route network will increase the number of bonus miles accumulated. In a geographical area dominated by a single carrier, there would be little point in joining any other carrier's scheme anyway. Larger airlines also offer a greater choice of routes on which to use accumulated bonus points or miles and are more likely to serve a variety of potential holiday destinations. One airline president is quoted as saying: *The frequent flyer game may have become a standoff between American and United, between Eastern and Delta. But they have clearly shifted traffic to the major airlines from the smaller carriers*, (*Business Week*, 27 August 1984).

routes had more than three or four airlines providing service. Naturally, the smaller carriers protested. They argued that FFPs, like CRSs, stifle competition and deny access to new entrants.

The General Accounting Office, a research agency of the US Congress into public policy issues, submitted a report to the Congress in 1990 according to which conditions in the airline industry were less conducive to competition than predicted in 1978. FFPs together with the CRSs and slot controls were seen to discourage competition more effectively than did the government regulation of the market for air transport before the Deregulation Act of 1978. B. K. Humphries makes this comment:

> *The concept of transferable mileage has recently been supported by the US General Accounting Office. Requiring frequent flyer schemes to allow their participants to transfer earned mileage to other participants within the same scheme would, according to the GAO, remove the need for passengers to concentrate all their flying on the dominant airline in each market. Instead they could spread their flying across several airlines and sell off the bonus miles that they could not themselves use. A more radical proposal would require airlines to honour bonus miles earned on other carriers. However, as the GAO points out, this could disadvantage certain airlines, particularly those whose route networks include the more desirable holiday destinations. At the same time, it would certainly remove many of competition concerns currently associated with frequent flyer programmes*[157]

Another, just as significant factor, was that low redemption of awards remained crucial to the management of FFPs and, with an average of approximately only 25 per cent of the miles redeemed, airlines were hostile to any attempts to increase this figure, thereby directly affecting their profits.[158]

The US Internal Revenue Service has not intervened in any way that would challenge the viability of frequent flyer programmes, even though frequent flyer benefits are considered to be income liable for taxation. The difficulties associated with taxing the programmes were probably considered too great compared with the size of the likely revenues involved. B. K. Humphries remarks: *Similarly, there is little sign that the political will exists within the US Department of Transportation, in the face of inevitable opposition from the major airlines and a large proportion of passengers, to intervene on airline competition grounds.*[159] So far frequent flyer programmes have been allowed to remain on the American air transport scene without any public authority intervention.

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157 Although in violation of current FFP rules, a broker system such as this already exists on the American market, although its existence has been seriously threatened as a result of a series of successful lawsuits launched by the major airlines. Humphries, B.K., *op. cit.*, p. 14.

158 Mason, G. and N. Barker, *op. cit.*, p. 222.

159 Humphries, B.K., *op. cit.*, p. 15.

B. FFPs in the European Community

The European airlines were aware of the developments on the American market and by the mid 1980s started to prepare themselves for the coming liberalization in Europe. Unlike their US colleagues, who had had to fight their way through deregulation, the European carriers could be much more relaxed about liberalization. They had considerable advantages over their US counterparts. One of the most important advantages was that the European airlines already had a hub and spoke network, as the capital of the national state had been used as the natural hub of the national airline's network right from the beginning. There was thus no need to reorientate a linear system as the American airlines had to do. In Europe, the carriers had their respective national markets to themselves, and the protection afforded by regulation had made it possible to operate without external or internal competition.

Up until the late 1980s, only the US airlines featured FFPs. But as it became increasingly popular for European consumers flying to the US to fly with US airlines on their transatlantic flights, they were recruited in growing numbers as members of the US programmes. In the late 1980s, a survey of the European passenger market presented a picture which jolted the European airlines. This picture was of lost transatlantic high-yield traffic to the American airlines. Some European airlines had been linked to the US airlines' FFPs, for example BA had joined AA's, and had cooperation agreements with other US carriers. Soon, other European airlines followed this trend in order to avoid losing more traffic to their US counterparts. But still none of them featured their own FFP. At the very beginning of the 1990s, this changed. At this time, the company called *Air Miles* was formed, a company in which British Airways had a majority stake. This company operated a scheme which was not an FFP, but bonus miles were accrued by buying non-aviation products and were then redeemable on British Airways' services. The next step was that Virgin Atlantic launched its Freeway scheme in reaction to the creation of Air Miles. But the most important step which came to have great significance was the decision in April 1991 of British Airways to launch its own FFP, to be known as Latitudes. At this time, British Airways was undergoing the process of privatization and, although it was dominant, it had competitors which were locally based, namely Virgin Atlantic and British Midland on important portions of the home market. Latitudes was launched to compete with them, initially only in the home market of BA. But at this time TWA and PanAmerican no longer existed, and two new mega-carriers of US air transport, AA and UA, had purchased the transatlantic routes formerly operated by TWA and PanAm. They now posed a new competitive threat to BA. BA's investment strategy also needed maximum marketing power and BA had to make the most of its competitive advantages through its CRS, nicknamed BABS, by making use of incentive payments to agents and slot preferences as well as its FFP, if it were to draw traffic successfully and achieve its goal of surviving as a global mega-carrier. Latitudes shared many of the characteristics of the US programmes, but there were also a number of refinements. For example, bonus miles could be earned only by the purchase of certain fare types, namely those used by business passengers (Concorde, Club World and Club Europe). As soon as BA had introduced its own programme, AA and UA promptly terminated their arrangements with BA for AA and UA frequent flyer members to redeem miles on BA transatlantic flights. They were now the ones afraid of losing

high yield business to BA because of its FFP, its dominant position at Heathrow Airport, where it had a large number of slots, and its high reputation for service. Elsewhere on non-competing routes, FFP alliances of this type were allowed to remain intact. Throughout 1991 and 1992, most competing European carriers could see the way things were going and launched their own plans, but compared with AA's 16 million and UA's 12 million members, BA's 186,000, KLM's 120,000, SAS' 70,000, Air France's 95,000, Iberia's 100,000 and Swissair's 100,000 remained modest in size.[160] The difference between the US and European experiences could be explained by the newness of FFPs in Europe, but also because the European FFPs remained more restrictive in scope than their US counterparts. The national flag carriers already dominated their domestic markets and when they introduced FFPs during the first years of liberalization, it was not so much to be in a stronger competitive position on their own market, but rather to fend off the US FFP threat. However, when, thanks to liberalization, mainly the introduction of the third package in 1993, new, small competitors entered the market, the European FFPs came to fulfil the same function as they had had for the big US carriers a decade earlier: they helped to keep the new, small competitors at bay. The European carriers were quick to copy the US systems, using their own CRSs to control their frequent flyer schemes, thereby making it even more difficult for the new, small competitors. The Chairman of Ryanair, Patrick Murphy, believes that FFPs present a real threat to smaller new entrants: *Frequent flyer programmes are an anti-competitive method of developing customer loyalty and Ryanair believes that they should be banned in Europe... small airlines simply cannot match such indirect incentives and compete profitably*[161]

The Commission considers that a frequent flyer programme may be an important means of tying customers to an airline as effectively as requirement contracts in other sectors, rendering it more difficult or even preventing competitors from entering the market profitably and thus infringing Article 85(1) of the Treaty. The possible impact of FFPs on competition has been assessed from three different points of view by the director of DG IV, Humbert Drabbe[162]:

> *Competition between incumbent airlines and new entrants:*
>
> *A FFP may be considered to constitute a barrier to entry for new entrant airlines with a small route network. … Potential passengers, already members of the incumbent's FFP, are unlikely to make use of the new entrants' services on routes overlapping with the network of the incumbent. … Passengers are more likely to join a major airline's FFP than one offered by a small carrier because a larger route network increases the possibilities for the passenger to accumulate usable bonus points. …*

160 Verchère, Ian, *op. cit.* 1993, p. 16. In Ian Verchère's 1997 article, the membership figures provided by Catherine Chetwynd are as follows: AAdvantage: worldwide, 28 million; UA: not available; BA: worldwide, 1 million; KLM: not available; SAS: 1 million; Air France: 1.3 million; Iberia: worldwide, 450,000; Swissair: not available. Verchère, Ian, *op. cit.* 1997, pp. 31-36.

161 Remarks in *New Entrant Airlines - A Case Study* prepared by RB Associates for DG IV, June 1992, p. 43.

162 A 1996 unpublished paper by Drabbe, Humbert, director of DG IV, European Commission, *Frequent Flyer Programmes Competition Aspects*.

Facing these difficulties a new entrant might of course decide to give direct rebates in order to offset the disadvantages of a small network. This, however, will increase the costs of the new entrant as rebates must be paid at the moment of sale of the ticket, unlike the case of a FFP where the "rebate" will occur in the future and then only if sufficient points have been collected by the passenger.

It will therefore not come as a surprise that in a study done for the Commission concerning new entry in air transport in 1992, it was confirmed that FFPs can act as an anti-competitive method employed by larger carriers which cannot be matched by small airlines and impedes them from competing profitably.

Competition between carriers of similar size:

The operating patterns of the incumbent carriers of similar size are typically determined by a strong market presence of each of those carriers in its traditional (national) "home market" and a reasonable but much less developed presence in other parts of the Community.

The overall impact of FFPs on competition between such carriers is - a priori - difficult to assess. …

When looking at the effect of a FFP on competition, it is important to remember that FFPs have been introduced and based on the hub and spoke system. FFPs are primarily aimed at consolidating the position of an air carrier on its hub and serve as a marketing tool for attracting additional traffic to and from the spoke destinations where the operating carrier's position is less well developed.

Competition between Community carriers and non-community carriers, especially US carriers:

US carriers have been the first to introduce such schemes to the North Atlantic-market. The mere size of the US domestic market provided US carriers with unique marketing opportunities when they allowed US travellers to accumulate bonus points on both domestic and international routes. …

The decision of European carriers to offer similar schemes was, therefore, to a large extent, a commercially logical (and necessary) defense to the programmes offered by US carriers. The existence of large-scale FFPs "made in USA" reinforces the competitive advantages which US carriers have gained in transatlantic markets by the size of the US domestic market.

In 1992, even though no formal complaint was lodged with the European Commission, the Commission sent on its own initiative a request for information to all larger European carriers in order to assess the effects of the different FFPs in Europe. The Commission's Competition Directorate, DG IV, carried out an informal study on the basis of this information and examined the effects of FFPs on competition. The result of the study was that FFPs as such could not be considered to be anticompetitive, but in case of alliances or mergers, FFPs might constitute a barrier to entry in the same way as the limited availability of slots. On this basis, the Commission took no further action against FFPs as such, but it took a position as regards FFPs and the application of the competition rules in four cases. The first case concerned the merger between Air France and Sabena (1992) which was considered under the Merger Regulation 4064/89.[163] The Commission checked the following two questions: 1) whether the transaction between Air France and Sabena created or strengthened a dominant position for the two airlines and 2) whether competition in the common market was significantly impeded by the potential dominant position obtained by the two airlines as a result of the merger. The Commission decided that on the routes operated by the two airlines before the merger, which they would now operate jointly, their FFPs did in fact represent a barrier of entry to new airlines, and thus reinforced their dominant position. The two companies undertook to offer competitors who did not directly or indirectly participate in an FFP the opportunity to participate in Air France's and Sabena's FFP under reasonable and non-discriminatory financial conditions. In the BA-TAT merger case, BA and TAT made the same undertaking as far as the route London Gatwick-Paris was concerned.[164] The same approach was followed in the 1995 merger between Sabena and Swissair and gave rise to the same commitments on the routes between Brussels on one hand and Zurich, Geneva, Basel and Berne on the other.[165] A much more comprehensive decision was taken by the Commission in January 1996 in the fourth case which related to the alliance set up between Lufthansa and SAS, which was considered under Article 85 and not under the Merger Regulation. According to the decision, *the pooling of FFPs is an aspect which must be taken into account in assessing the economic power of the undertakings. Most of the customers are business travellers, and they will clearly prefer airlines that have a joint FFP allowing them to earn points whatever the airline used. A common system is thus likely to constitute a not inconsiderable entry barrier to other airlines that do not have comparable programmes*.[166] In order to limit this restrictive effect of the pooling of their FFPs, the Commission required Lufthansa and SAS to undertake that *any* other airline which provided or wished to provide services on the *most important routes* covered by the alliance and which did not have an FFP applicable at international level would be given the opportunity of participating in the programme operated by Lufthansa and SAS.

The Commission's standpoint at present is in other words that FFPs may be considered anticompetitive in relation to Article 85 or the Merger Regulation, if they are elements in

163 The merger between Air France and Sabena, as well as the three cases described in the following, have all been dealt with above in Part II, Chapter 4 B and C.
164 Commission Decision of 11 December 1992, O.J. C 326 11 December 1992.
165 Commission Decision of 20 July 1995, IP/95/805.
166 Commission Decision of 16 January 1996 96/180/EC.

alliances or mergers which themselves may be anticompetitive and incompatible with the common market. The Commission decides this on a case-by-case basis. If the Commission allows the alliance or the merger, it is made a proviso that the partners to the agreement allow new entrant airlines to participate in their FFP on fair terms and conditions.

So far the Commission has not had the opportunity of considering whether an FFP might constitute an abuse of an airline's dominant position under Article 86. Community law does not prohibit large airlines from taking advantage of their networks and exploiting size-related advantages when marketing their services. As long as the marketing strategies employed by an airline do not amount to an abuse in the sense of Article 86 difficulties arising for smaller competitors from such legitimate exploitation of size-related advantages must be accepted.

In order to apply Article 86 it must be first be established that the airline employing an FFP has a dominant position on single routes or a bundle of routes served out of its hub. The next step is then to determine when the operation of the FFP may be considered abusive.

The relevant principles governing the distinction between price reductions which are non-abusive competition and price reductions which fall within the scope of Article 86 were established by the European Court of Justice in the Hoffman-La Roche and Michelin judgments.[167]

In these cases the Court investigated: 1) whether discounts or price reductions removed or restricted the buyer's freedom of choice and 2) barred competitors from access to the market or 3) strengthened the dominant position of the undertaking by distorting competition.

In the Hoffman-La Roche judgment, the Court considered that *fidelity rebates* through the grant of financial advantages are designed to prevent customers from obtaining their supplies from competing producers - unlike quantity rebates exclusively linked with the volume of purchase from the producer concerned. If the grant of the fidelity rebate is based on an undertaking from the purchaser to obtain all or most of his supplies from the supplier, then it is abusive conduct.

In the Michelin judgment the Court considered that *target rebate systems*, namely systems whereby the granting of the rebate is conditional upon the attainment of a certain target, were abusive. The Court argued that, towards the end of the reference period set for the attainment of the target, the purchaser is under considerable pressure to reach the target, or lose the rebate, thus discouraging him from choosing freely at all times between the offers made by different suppliers.

167 Case 85/76, *Hoffmann-La Roche & Co. AG v. Commission*, [1979] ECR 461 [1979] 3 CMLR 211. Case 322/81, *N.V. Nederlandse Bänder-Industrie Michelin v. Commission*, [1983] ECR 3461 [1982] 1 CMLR 643.

Both the Hoffman-La Roche and the Michelin judgments apply to products and not to services and thus cannot be applied directly to FFPs. However, as a rule of thumb, the following two results are indicated:

1) If an FFP is to be considered a fidelity rebate, it must be based on the explicit or implicit condition that the passenger will obtain all or most of his supplies in air transport services from the airline operating the FFP. As all FFPs have a wide application and normally entail an open invitation to all passengers to become members, independent of their individual demand for air transport services, it is highly unlikely that such an FFP will be considered abusive within the meaning of Article 86.

2) If an FFP is to be considered a target rebate, the granting of the rebate must be conditional upon the attainment of a certain target, for example a certain number of bonus points within a specific reference period, in order to obtain a free flight. Particularly towards the end of the reference period, the passenger may be under pressure to reach the target. Many FFPs are designed in this way and accordingly fall within the scope of Article 86. If, as in many of the schemes, the cut-off dates are rolling, i.e. linked in each case to the date on which the points were awarded, this result is less likely. On the other hand, the fact that many airlines reserve their right to alter the terms of the programme and to introduce new time limits, blackout periods and - indeed - to terminate the scheme practically from day to day, the application of Article 86 seems even more justified.

The Commission has been unwilling to take a general stand on FFPs, but maintains its case-by-case approach unflinchingly. So far Article 86 has not been applied to any of the programmes. The question remains: are FFPs desirable marketing strategies? If not, what can be done about them? This question will be considered in more detail in Part IV C.[168]

Ian Verchère writing about FFPs in Europe in 1997 describes the situation as follows:

> *Mean while, Brussels has been able partially to defend the interests of new entrants by insisting they be allowed to participate in the FFPs of dominant alliances - such as Lufthansa-SAS - on those sectors involved. As a result, says Humbert Drabbe, "no complaint has so far been lodged with the Commission as regards FFPs." In evaluating FFPs under Article 86 of the EU treaty, their "wide scope of application" makes it unlikely they will be seen to have abused market dominance. Similarly, where FFP points are accumulated over a continuously changing period is less of a problem*

168 A 1997 unpublished paper by Durande, M., an official of DG IV, European Commission, *Frequent Flyer Programmes Competition Aspects*. A 1996 unpublished paper by Drabbe, Humbert, director of DG IV, European Commission, *Frequent Flyer Programmes Competition Aspects*.

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than programmes which "put special pressure on a passenger at the end of a calender year". "The FFP is only one of the modern commercial management tools used in the aviation sector," says Drabbe. "Other examples are the CRS, yield management, franchising and creation of hubs." The Commission has paid great attention to the development of the FFP and never intervened to limit it. In the context of an alliance or merger, however, it has to assess the effect of the pooling of FFPs on "access to transport markets". In short, it keeps a close watch on developments but has so far shown no inclination to abolish the FFP. Pending any changes to such attitudes, therefore, Europe's frequent flyer culture will remain a critical part of airline marketing, with the emphasis on building customer relationships. Here the buzz words are data mining. Tony Clarke, managing director of International Customer Loyalty Programmes, says developing a relational database is the main objective. "It should allow the capture and easy access of customer profiles," he explains, "including preferences, demographics, and lifestyle information and be able to capture purchasing and interaction information[169]

The development of CRSs in Europe also played a significant role in relation to FFPs, because they enabled the airline companies to register and keep count of frequent flyer points:

The American CRSs began to enter the European market in the 1980s. As a countermove to this initiative, Lufthansa, SAS, Air France and Iberia considered the establishment in 1987 of a joint reservation system. This led to the introduction of the CRS called Amadeus in 1992 - which used the technology of System One. SAS, however, is no longer co-owner of Amadeus. The second European CRS, Galileo, was formed in 1987. Galileo and Apollo (Covia) were amalgamated in 1993 and Galileo International was established. At this point in time, the largest CRSs were renamed GDSs, Global Distribution Systems. In April 1995, Continental Airlines sold their shares in System One to EDS (the world's biggest systems integrator and leading supplier of IT services) and to Amadeus, which thus became co-owners of System One. … The European GDS market is shared between the national airlines as follows: Amadeus dominates in Germany, France, Spain and Scandinavia, whereas Galileo dominates in Great Britain and Holland (British Airways and KLM). … There are exceptions. Sabre are thus very powerful in France, and Sabre are also advancing in Great Britain. Worldspan, an American GDS, is advancing in Europe. On the other hand, Amadeus, which had taken over the American GDS System One, has now entered the American market[170]

169 Verchère, Ian, *op. cit.* 1997, p. 31.

170 Translated from Marcussen, Carl Henrik, *op. cit.*, pp. 110 and 152. According to Commission Report of 9 July 1997 COM(97) 246 final, p. 8, there are five CRSs operating in the EU, namely Amadeus, Galileo International, GETS, Sabre and Worldspan.

The Council and the Commission of the EC have looked critically at CRSs several times. Primarily the problem of biasing the CRSs led the Council to adopt a regulation in July 1989 establishing a Code of Conduct for CRSs. As the code constituted a completely new area of legislation, without any prior practical experience, there were some difficulties of application. The Commission published an Explanatory Note in July 1990, but this did not solve the problems. After the code of conduct had entered into force in August 1989, the Commission had received 28 complaints or requests for interpretation concerning inter alia: access to the display of flights; fees charged to participants; display of fares; participation in competing CRSs and a free provision of hardware to subscribers. This led to a Commission proposal for the amendment of the 1989 code of conduct. The amendment clarified the following issues: 1) It introduced a definition of subscribers as natural persons and corporate users; 2) concerning the loading of data into a CRS, the participating carriers and others providing data to be submitted to the CRS were made responsible for the quality of the data they provided; 3) information generated by a CRS was to be offered to all participating carriers at the same time; 4) the principal display must be accessed first, except where a consumer requests information for only one carrier; 4) clarification was made concerning the order in which information was presented; 5) an obligation to include non-scheduled services was introduced; 6) an obligation was imposed on a parent carrier not to discriminate against a competing CRS; 7) the system vendor was obliged to offer non-discriminatory fees for the use of the system; 8) rules for the termination of a contract between a participating carrier or a subscriber and a system vendor were introduced as well as rules for the use of intelligent PCs and third-party software. At its meeting of 29 October 1993, the Council unanimously adopted the amended code of conduct. The amended text, which had its legal base in Article 84(2) of the EC Treaty, stipulated among other things that CRS parent carriers are to communicate information to another CRS which requests it, and air carriers which own CRSs must observe the requirements of non-discrimination towards other carriers in respect of information displayed in their own computerized system. The Regulation came into operation on 11 December 1993.[171]

In December 1993, the Commission adopted a new block exemption in the field of CRSs for air transport services which replaced the former block exemption which had expired on 31 December 1993. The block exemption covers agreements between companies, the purposes of which are: 1) to purchase or develop a CRS in common; 2) to create a system vendor to market and operate the CRS; 3) to regulate the provision of distribution facilities by the system vendor or by distributors. In comparison to the expired block exemption, the new regulation introduces the following modifications: 1) an obligation for the system vendor providing improvements in the distribution of the system to give information on these improvements and to propose them to all participating carriers; 2) an obligation for parent carriers to provide to a competing CRS on request the information it provides on its own CRS concerning schedules, fares and availability; 3) an obligation for the system vendor to separate its distribution functions from its private inventory and management facilities in its computer system; 4) an

171 The 1989 Code of Conduct for CRSs, Council Regulation No. EEC/2299/89 (O. J. No. L 220 of 29 July 1989). The Commission's Explanatory Note of July 1990 (O.J. No. C 184 of 25 July 1990, p. 2). The amended Code of Conduct, Council Regulation No. EC/3089/93 (O. J. No. L 278 of 11 November 1993, p. 1).

obligation for the system vendor to see that the invoices of the CRS services are sufficiently detailed so that participating carriers and subscribers can see exactly what services were used and the fees for them.[172]

In July 1997, the Commission published a report on the revision of the 1993 Code of Conduct for CRSs.[173] The report contained proposals for amending the 1993 Code of Conduct in order to update the Code and enable it to keep up with developments in the air transport sector during the following years. The report followed after discussions between the Commission, the CRS industry, the airline companies and subscribers of the CRSs concerning chiefly calculation of CRS fees and the rapid development in new distribution methods such as electronic tickets and the Internet. Following the 1993 amendment of the Code of Conduct, the Commission received 22 complaints, including that certain facilities were made available by a CRS to its owner airline, the offer of which was refused to other airlines, particularly during the period when the CRS in question transferred from the multi-access system to the present neutral global core system. Other complaints concerned: 1) the calculation of fees, which was maintained to be biased in favour of the owner airline; 2) the protection of information concerning individual passengers; 3) bias in the display of flights; 4) market access for a European CRS in third countries as well as market access for third country CRSs in the EU; 5) unreasonable contract terms and ticketing. There were no infringements concerning data safety, and the Commission had authorized the data protection arrangements for the four CRSs in September 1995 and for the remaining one in January 1996.[174] Viewed as a whole, the 1993 Code had functioned satisfactorily and was a significant contribution towards just competition on the CRS market, but there were problems chiefly in the area of the calculation of fees. In its report, the Commission proposes to lay down new rules for the calculation of non-discriminatory fees. Furthermore, the Commission proposes to regulate the presentation of flights under a joint code and to require a more efficient supervision of the CRSs' fulfilment of the technical requirements of the Code. The Commission proposes to amend the Code in the area of minimum requirements concerning confidentiality and non-discrimination of information given to the customer. Reservations via the Internet do not at present fall within the scope of the Code. The Internet functions only as an advanced line of communication

172 The new block exemption regulation entered into force on 1 January 1994 and expires on 30 June 1998, Commission Regulation No. EC/3652/93 (O. J. No. L 333 of 31 December 1993, p. 37).

173 Commission Report on the implementation of Council Regulation No. EEC/2299/89 on a Code of Conduct for CRSs, including a proposal for amending the Code of Conduct (Commission Report of 9 July 1997 COM (97) 246 final).

174 Commission Report of 9 July 1997 COM (97) 246 final, p. 7. One complaint concerned the fact that all CRSs based in the USA refused to provide airline companies outside the USA with marketing data on domestic flights in the USA. This was in accordance with the American code of practice which at that time provided that marketing information on domestic air transport in the USA could only be given to American airline companies. The EU Code of Conduct, on the other hand, laid down that a CRS must provide marketing information to all participant airlines regardless of nationality, unless the CRS was discriminated against by a third country. Accordingly, Amadeus informed the Commission that it would stop providing marketing information to the American airline companies. The Commission found that this was an example of serious discrimination and started negotiations with the US Department of Transportation, with the result that the CRSs in the US were exempted from the American rules so that marketing data on American domestic air traffic could be sold to European airline companies (Commission Report of 9 July 1997 COM (97) 246 final, p. 6).

between an airline or a CRS and its subscribers, but does not itself contain information about air transport services. In other words, the Internet and such systems are regarded as communication networks, not as CRSs. The Commission proposes that the Code be amended to cover such communication networks in the future.[175] The Commission proposes amendments which will ensure that subscribers do not provide their customers with inexact, misleading and discriminatory information. The Commission proposes that train transport services can be integrated in the air transport CRS presentations.[176]

C. FFPs in the Scandinavian countries

In Denmark, specific legal regulation of frequent flyer programmes in the area of marketing law exists, but Denmark is the only country in Scandinavia with statutory provisions for FFPs.

In the Nordic countries, the three major airline companies, SAS, Icelandair and Finnair all have frequent flyer programmes with very similar contents. Since their introduction by the airline companies in 1992, they have been considered by the Consumer Ombudsmen and the Competition Authorities in various contexts.

In *Danish marketing law,* frequent flyer programmes are categorized as collateral gifts. Collateral gifts, or *throw ins*, are defined in Scandinavian marketing law as goods or services offered as a free gift which are given to the consumer when he/she buys some other particular goods or services. Collateral gifts represent a price advantage - a form of discount - but the consumer cannot choose to have the price of the collateral gift paid to him in cash.[177]

In Danish marketing practice law, the *offer* of collateral gifts was prohibited in the first Act of Parliament concerning unfair competition in 1912. This prohibition has been upheld, though worded differently since then. It remains a bone of contention whether it should be abolished or not.[178] The Danish Marketing Practices Act, which was first introduced in 1974, prohibits the use of collateral gifts in its section 6(1)-(2), unless the gift is of little value or is of exactly the same nature and category as the goods which the consumer buys with the gift; in other words, quantity discounts are allowed.[179] The *advertisement* of the offer of such collateral gifts is also prohibited.

The background to the introduction of special rules for frequent flyer programmes in the Marketing Practices Act dates back to 1989, when British Airways was prosecuted for illegal

175 Commission Report of 9 July 1997 COM (97) 246 final, p. 18.
176 *Ibid*., p. 22.
177 Madsen, Palle Bo, *Markedsret Del 2 (Marketing Law Part 2)*, DJØF, Copenhagen, Denmark, 1997, p. 253.
178 In the Commission Report No. 416/1966 on the revision of the Competition Act, it was proposed to abolish the prohibition but without success. Exactly the same happened in 1992 in the Report No. 1236/1992 on the revision of the Danish Marketing Practices Act. The present social democratic minority government put forward the abolition of the prohibition in its proposals for a new consumer policy in April 1997, Madsen, Palle Bo, *op. cit.*, p. 193. But the prohibition remains in the Act (as of March 1998).
179 The Danish Marketing Practices Act now in force is Act No. 428 of 1 June 1994.

advertising of its frequent flyer programme in the Danish newspapers and fined under section 19(3) and (6), c.f. section 6(1)-(2), of the Act.[180] In other words, the prohibition in section 6(1)-(2) applied to frequent flyer programmes in exactly the same way as other forms of free gifts offered to the consumer when buying goods or services. But in 1992, SAS argued that the company had to be allowed to market a frequent flyer programme if the airline were not to lose its customers to other airlines offering FFPs. The Danish Parliament accepted this argument and a special provision exempting frequent flyer programmes from the prohibition in section 6 of the Act was introduced. It was recognized that the airline industry is international in character, and that SAS was in a disadvantageous position in competition with the other international airline companies to whom no such prohibition applied when marketing their frequent flyer programmes. The exemption was included in the 1994 general revision of the Marketing Practices Act in section 6(3)-(6). Thus it became allowed for airline companies *when selling air transport and similar services to offer collateral gifts to their customers in connection with a frequent flyer programme* (section 6(3)), on two conditions: 1) the FFP must be marketed internationally as an integrated part of the normal activity of the airline; 2) the essential element in the programme - as marketed in Denmark - must be the offer of collateral gifts (bonus savings) in connection with the sale of *air transport*. If the airline has business partners, the FFP may also include car rentals and hotel accommodation, section 6(5). Thus, the airline may cooperate with other airlines, hotel chains and car rental firms. These limitations do not apply, if a competing airline offers other forms of collateral gifts in its programme, but in this case the Danish Consumer Ombudsman must be notified, section 6(4).[181] According to section 6(3)(2), it is permitted for other businesses to offer collateral gifts in the form of transport, hotel accommodation and car rental if the offer is made as an integrated part of a frequent flyer programme.

180 British Airways had advertised in all the major Danish newspapers, inviting Danish travellers to become members of its FFP *Club Europe*, which would give its members the advantages of 24 hours free parking and free coupons for the purchase of duty-free goods in Heathrow Airport, a free return ticket for the underground, a free phone card, coupons for London taxis and many other privileges. British Airways was fined 25,000 Danish kroner for infringing section 6(1)-(2). *Ugeskrift for Retsvæsen (The Danish Legal Gazette)*, 1990.765 SH. As described above in the text, the 1992 amendment of section 6 which allowed SAS to market its frequent flyer programme was somewhat unclear in its wording, because it did not expressly limit the exemption for airline companies. This lack of clarity led to another court case. The case concerned a hardware chain cooperating with a Danish package travel organizer. The hardware chain gave coupons to costumers purchasing a fridge or a cooker. The coupons were to be used by the customer when purchasing a package from the travel organizer, and the coupons entitled the customer to a 50 per cent reduction in the price of the package. The hardware chain was acquitted, despite the fact that it had never been the intention that other businesses than airline companies should make use of the exemption in section 6(3)-(6). *Ugeskrift for Retsvæsen (The Danish Legal Gazette*), 1993.645 SH. Accordingly, the provision was clarified in the 1994 revision; section 6(5) was introduced according to which the frequent flyer programme must be established by the airline company *as an integrated part of its normal activity*.

181 So far the Ombudsman has received no notification under this provision. It was introduced in the Act to allow airlines (SAS) to introduce other forms of bonus in their FFP, if this were to become necessary, i.e. if other airline companies marketed such bonus savings in their FFP.

In *Norwegian marketing law*, the offer of collateral gifts is prohibited as it is in Denmark.[182] According to section 4(1) and (2) of the Norwegian Control of Marketing Practices and Contract Terms Act:

> *Businesses may not attempt to promote the sale of one or more products, services, other performances or yields by offering a collateral gift to the consumer.*
>
> *Collateral gifts are any additional product, service or other benefit which is associated with the sale of the primary goods or services without any natural connection between them. Payment in cash is also considered as a collateral gift in cases where there is no natural connection between that and payment for the primary goods or services, or if coupons or other similar documents are used for the purpose of proof of entitlement to the cash benefit. It is also a collateral gift if the additional benefit is of little value*

The provision in section 4(2) which prohibits collateral gifts in the form of *trading stamps* has no direct parallel in the other Nordic countries. The Norwegian Act has no statutory provision corresponding to section 6(3)-(6) in the Danish Marketing Practices Act which allows airlines to market FFPs.

The *Norwegian Consumer Ombudsman* took a critical look at SAS's EuroBonus programme when it was first introduced in 1992. Having looked at the marketing material, the Ombudsman informed SAS that the cumulative saving of bonus points which was registered electronically by SAS fell within the scope of the prohibition against trading stamps. Furthermore, the Ombudsman argued that EuroBonus would limit the consumers' freedom of choice and bind them to SAS. Also that the existence of the bonus programme made it impossible for consumers to compare the price of a ticket offered by SAS with that of a similar ticket offered by a competing airline. The Norwegian Consumer Ombudsman thought that SAS's marketing of the programme was aimed at attracting not only business travellers but also ordinary consumers, because the minimum number of points to be saved was set at a very low level. SAS replied to this by using the same arguments the airline had used when it persuaded the Danish Parliament to amend the Danish Marketing Practices Act: *If SAS was not allowed to market its FFP, the airline would not be able to survive in the international competition between airline companies all of which depend on attracting customers by marketing an FFP*. SAS added that the bonus programme offered excellent possibilities for direct marketing and that passengers who had saved up free bonus trips travelled in empty seats and thus did not cost the airline anything. Furthermore, SAS could exploit the low season by increasing the amount of bonus points to be saved on each flight or by special offers to bonus travellers. SAS maintained that the airline had not infringed the prohibition against trading stamps, but was

182 The Norwegian Control of Marketing Practices and Contract Terms Act, No. 47 of 16 June 1972 with later amendments, most recently Act No. 15 of 31 January 1997. The prohibition goes back to the Norwegian Competition Act of 1922. It has survived in Norway as it has in Denmark. Discussions to abolish it in 1985 proved fruitless.

willing to raise the minimum number of points required, so that the private consumer would not benefit so easily by the scheme. On this background, the Ombudsman decided not to proceed further in the case even though the plan had originally been to sue SAS.[183]

In 1994, the *Norwegian Competition Authority* considered the problem of whether SAS was abusing its dominant position in Norway by retaining its hold on customers by means of its FFP, thus preventing them from flying with a competing airline, particularly on domestic routes. The Authority maintained that the introduction of the EuroBonus programme made business travellers less price conscious when purchasing airline tickets for business travel. Business travellers were apt to consider primarily or even exclusively the maximum accumulation of bonus points. This tied business travellers to the SAS EuroBonus programme and hindered free competition between airlines. The argument applied even more strongly to those members of the programme who had almost saved up a sufficient number of points to obtain a free ticket. They would not be likely to change to another airline, even though the competing airline might offer better prices or services. Since SAS was the only Norwegian airline operating on both international and domestic routes, SAS would be able to retain its hold on domestic travellers in competition with the other domestic airlines by means of their EuroBonus programme, since this was the only programme offering bonus savings both on international and domestic flights. The same argument applied to SAS's business partners such as their hotel chains and car rental firms which benefitted by the EuroBonus programme in a way that other domestic airlines, hotel chains and car rental firms could not. However, the Norwegian Competition Authority decided not to intervene, because of the competitive disadvantage this would put SAS at internationally.[184]

The new *Swedish Marketing Practices Act* of 1995 does not prohibit collateral gifts, but its section 13 imposes an information duty on businesses offering collateral gifts:[185]

> *A business which in connection with its marketing offers to the buyer the acquisition of other products for free or at a particularly low price, or offers other separate bonuses to the buyer, must provide clear information about:*
>
> *1) the conditions for taking up the offer,*
>
> *2) the nature and value of the offer and*
>
> *3) the time limit and other limitations which apply to the offer.*

The Swedish Act has no statutory provision corresponding to section 6(3)-(6) in the Danish Marketing Practices Act which allows airlines to market FFPs.

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183 Unpublished correspondence between SAS and the Norwegian Consumer Ombudsman, 8 May-18 September 1992.

184 Unpublished correspondence between the Norwegian Competition Authority and the Norwegian Consumer Ombudsman in February 1994.

185 The Swedish Marketing Practices Act SFS 1995:450 of 27 April 1995.

In Sweden the Swedish Institute Against Bribery and Corruption[186] looked critically at the introduction of SAS' EuroBonus programme in 1992. The reason for the involvement of the Swedish Institute was that the Swedish Local Authority Taxation Act[187] was amended in 1991 so that loyalty bonuses under the airline companies' frequent flyer programmes were exempted from taxation even though they were taxable benefits under the Income Tax Act. This was done to enable SAS to compete on an equal basis with the other international airline companies in Sweden. It is a parallel to the Danish amendment of section 6 of the Marketing Practices Act which exempted frequent flyer programmes from the prohibition against collateral gifts in 1992. The Institute considered whether or not FFPs could be regarded as bribery from the point of view of the airline company which offers a frequent flyer bonus to the business man or woman who travels on behalf of his/her company and at its expense and whether they are therefore an offence against chapter 17, section 7 of the Swedish Criminal Act. The Institute also considered if it amounted to corruption for the employee to receive the benefit under chapter 20, section 2 of that Act. The Institute proposed that the frequent flyer programmes should only be accepted if frequent flyer bonuses earned on business travel became the property of the employer in the first instance so that the employer could give it to the employee or use it for the company's own purposes. It also proposed that the membership terms and conditions of the programmes should impose the duty of reporting point savings to the employer.[188] Furthermore, the Institute proposed that it should be a duty for employees always to make sure that their employers expressly accepted their private use of bonus points accumulated on business travel.[189]

Loyalty programmes as such - including the frequent flyer programmes of the Nordic airlines - were examined in 1994 by the *Nordic Competition Authorities* to see if there was a need to regulate them, but the discussion ended without any steps being taken.[190] That same year the *Norwegian Competition Authority* laid down guidelines concerning loyalty discounts generally. According to these guidelines, loyalty discounts were considered to have the same anticompetitive effects as exclusive-agency agreements. If the firm granting such discounts did this in order to strengthen its dominant position on the market and bind its customers to it, this would be considered as anticompetitive behaviour. If the firm did not have a dominant position on the market, loyalty discounts would not be considered anticompetitive according to the guidelines.[191]

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186 The Institute was established in 1923 by the Stockholm Chamber of Commerce, the Swedish Industrial Association and the Swedish Association of Commerce, all of whom remain principals of the Institute to this day. The task of the Institute is to spread knowledge through Swedish society about legislation concerning bribery and corruption and to create a climate in Swedish society against any initiatives which contain such elements.

187 Act SFS 1991:1866.

188 The SAS 1996 Swedish edition of the terms and conditions and the present Swedish taxation rules are referred to at notes 18 and 21 above.

189 The Report of the Institute Against Bribery and Corruption (Institutet Mot Mutor), *Flygbolagens förmånserbjudanden av typen "frequent flyer"-bonus (Collateral Gifts offered by the Airline Companies of the Type "Frequent Flyer"-Bonus*), Opinion 1992-06-12.

190 Interview with Anna Birna Halldórsdóttir of the Icelandic Competition Authority's Department for Consumer Affairs of 24 October 1996.

191 Guidelines from the Norwegian Competition Authority of 21 April 1994.

The *Danish Competition Authority* decided not to involve itself in the following case: in 1996, the airline Virgin Express started to fly the route Copenhagen-Brussels in competition with SAS. It could only obtain slots at very inconvenient hours, but the airline was able to offer tickets at 1/3 of the price demanded by SAS on the same route. As soon as SAS became aware of this, the airline decided to increase the number of bonus points to be earned by EuroBonus members travelling with SAS between Copenhagen and Brussels. As a result, travellers chose SAS in order to earn more points, and they did this even though they had to pay a much higher price for the flight. The same happened on the route Copenhagen-Stockholm, where Maersk Air and Finnair started flying in competition with SAS from 28 April 1997. Over a period of time, SAS increased the number of points to be earned on the route to retain its hold on customers. The same thing happened on the route Billund-Frankfurt.[192] The Danish Competition Authority did not take action, however, because it was realized that any such action would entail a weakening of SAS's powers to compete with other international airlines.[193]

In Denmark, Norway, Sweden and Finland the *Consumer Ombudsmen* have agreed to issue guidelines applying to loyalty programmes generally, i.e. to the loyalty programmes offered by supermarket and other shopping chains, oil companies as well as airline companies. The guidelines, which were published in June 1997, set out the requirements with which loyalty programmes generally must comply in order to be in accordance with the Marketing Practices Acts of the Scandinavian countries.

The main content of the guidelines is as follows. It is a general principle of Scandinavian marketing law that any person or company carrying out a business or a trade may not act in contravention of the legal standard of *good marketing practice*. Similarly, incorrect, misleading or unreasonably inadequate information - chiefly in the form of advertising - may not be used for marketing purposes. In order for a loyalty programme to live up to *the principles of good marketing practice and truth in advertising*, the individual loyalty programme must be sufficiently transparent and provide a reasonable basis of information for the consumer to make a decision. When the consumer becomes a member of the programme, the terms and conditions of the enrolment must be reasonable and may not involve any unacceptable commitments for him. Thus rights and obligations for the consumer must be clearly stated in advertisements and other forms of marketing material of the programme as well as in the enrolment forms.

Furthermore, there is an all-pervading requirement of *transparency* in Scandinavian marketing legislation. The various methods used by businesses - among them loyalty programmes - make

192 Article in the Danish newspaper *JyllandsPosten* on 21 April 1997.

193 Interview with Henrik Thomsen, official at the Danish Competition Authority in May 1997. The question is whether or not SAS can be regarded as having abused its dominant position on the national market. But this question cannot be considered separately from SAS's position on the international market and this is a matter for the European Commission.

it difficult for the consumer to determine the amount he is actually paying for a product he has bought. In other words, the price which the customer is paying for the actual product or service is blurred by the offer of a free gift. If the bonus system makes use of progressive criteria for earning points and offers heavily differentiated bonuses, this aggravates the difficulty of finding out what the price of the goods or services which the consumer is actually buying is. Other factors are added to this, such as the requirement of minimum purchases before a bonus can be obtained, time limits which make bonus points expire and time limits within which bonus savings must be used. In order to ensure transparency, it is necessary that a bonus should be calculated at any time as a precise sum of money which the customer can claim as soon as he has saved up a minimum number of bonus points. This number must be fixed at a fairly low level. Thus, it is undesirable for a business offering a loyalty programme to its customers to tie up saved-up bonus points in the firm over a long period of time. Bonus programmes which are constructed in such a way as to make it difficult or illusory for members to make use of bonus savings are basically in conflict with the requirement of good marketing practice. If a loyalty programme is connected with the use of payment cards such as the American Express or Diners' Club cards, the cash paying customer must be ensured access to the same discounts and similar advantages as the members. Advertisements and brochures should state clearly that discounts and other benefits are obtainable regardless of the manner in which payment is made.

Conclusion to Part III

The programme for liberalization of the European Community's air transport market was intended to benefit consumers in the form of lower fares, more choices and greater efficiency. The impetus for achieving these goals was planned to come from dynamic new entrant airlines with lower operating costs. The efforts at liberalization so far have mainly concerned the removal of administrative and regulatory obstacles to new entry, whereas the effort to prevent the existing major airlines from erecting artificial barriers of their own to new entry, for example in the form of FFPs, has been less intense. One of the most important lessons to be learned from deregulation in the US has been that the major, established airlines, with their financial resources and marketing advantages, can pursue commercial strategies which ensure their own survival at the expense of new entrants. New entrants may be forced to co-operate or merge with the major airlines since they cannot survive otherwise. In the US, this has led to the emergence of a narrow oligopoly of mega-carriers. In Europe, new entrant airlines have also had difficulties in entering the market, and the new entrants have themselves identified FFPs as an anticompetitive method employed by larger carriers which cannot be matched by small airlines and which impede them from competing profitably. However, no complaints about FFPs have been lodged with the European Commission. M. Durande of DG IV has written:

> *In 1992 the Commission sent on its own initiative a request for information to all larger European carriers in order to assess the different FFPs in Europe. It examined their effects on competition. The result was that FFPs as such were not anticompetitive but in case of alliances or mergers FFPs might constitute a barrier to entry in the same way as the limited availability of slots. Subsequently, it closed this procedure without any further action. So far the Commission has taken a position as*

regards the application of competition rules to FFPs in four cases [namely the three merger cases and the alliance described above in Part II C]. … Where the FFPs were seen as a barrier to entry and as reinforcing the dominant position of the two airlines [in the three merger cases], the two companies undertook to offer to those competitors who did not directly or indirectly participate in a FFP the opportunity to participate in their FFP under reasonable and non-discriminatory financial conditions. … [In the fourth case relating to the alliance set up between Lufthansa and SAS] the Commission considered in its decision of 16 January 1996 "that the pooling of frequent flyer programmes is also an aspect that must be taken into account in assessing the economic power of the undertakings. Most of the customers are businessmen, and they will clearly prefer airlines that have a joint frequent flyer programme allowing them to earn points whatever the airline used. A common system is thus likely to constitute a not inconsiderable entry barrier to other airlines that do not have comparable programmes." In order to limit this restrictive effect of the pooling of their FFPs the Commission therefore required LH and SAS to undertake that any other airline which provides or wishes to provide services on the most important routes covered by the alliance and which does not have a frequent flyer programme applicable at international level is given the opportunity of participating in the programme operated by Lufthansa and SAS[194]

In the US, the effects of FFPs on the structure of the market have been to strengthen the trend towards consolidation of the US airline industry after deregulation, because FFPs are particularly interesting for consumers where they make use of extensive and transatlantic networks. At present the situation in the European Community is characterized by the over dominance of flag carriers at their respective hubs. Such dominance may be reinforced by the operation of FFPs for essentially the same reason. The possibilities of regulating FFPs will be considered below in Part IV.

194 Op. cit., Durande, M., of DG IV, European Commission, pp. 7-9.

Part IV. Proposals for the Regulation of FFPs

A. Frequent flyer programmes as loyalty programmes and collateral gifts in Scandinavia

Frequent flyer programmes fall in the category of those marketing strategies which are lumped together under the heading *loyalty programmes*. These programmes all have the following two aspects in common. 1) They offer their members benefits for which they save up over a period of time, whenever they shop with the firm of whose programme they are members. The benefits vary from being regular discounts to offers of *free gifts* which are *thrown in* as a kind of benefit *on the side.* 2) They offer to the firms which make use of these marketing strategies the possibility of combining *relationship marketing* and *database management*.

Frequent flyer programmes as relationship marketing: According to B. K. Humphries *frequent flyer programmes give airlines access to large amounts of personal information about their important customers... such information is becoming increasingly important in airline marketing*."[195] In Scandinavia, this second element of FFPs has not been developed to any noticeable extent - at least not yet. Certainly FFPs are used for collecting information about members. The airlines are able to gather a lot of information about the personal preferences of their customers on this basis. At present at least, this information is only little used in the marketing communications between airlines and customers.[196] Advertisements and other communications in connection with FFPs are sent to members as direct mail, but advertising material has so far not been adapted to the personal circumstances of the members. However, once the airlines really start making use of their databases and the information stored there, problems connected with the uses of the information, data safety and protection of the consumer arise. Because these problems are not actual - merely potential - the subject of data protection in connection with FFPs is not considered in this paper. Very briefly the legal requirements in this sphere in the Scandinavian countries demand that personal and sensitive information may not be collected, registered and used by any company in such a way as to violate the integrity of the individual. Neither is the company in question allowed to act in an aggressive, importunate or annoying manner when collecting, registering and using information. Registered information should be administered in a way which is proper and ethical.[197]

Frequent flyer programmes as collateral gifts: The first element of frequent flyer programmes which was referred to above is the offer of a free bonus for which the customer saves up. Frequent flyer programmes can thus be regarded as a form of collateral gift, as the

195 Humphries, B.K., *op. cit.*, p. 13. Kearney, Terrence J., *op. cit.*, p. 34, makes the same point: *Carriers have also been successful in creating brand loyalty in business travellers where markets are competitive enough for the passenger to have a choice. Membership lists of the frequent flyer programs have been of value to carriers in targeting market research and in direct mail programs.*

196 Beaver, Allan, *op. cit.*, p. 46, has the following comment: *In considering airlines' FFP costs, income and savings from FFP databases need to be taken into account: Airlines have not yet fully exploited the vast amount of information they are collecting about members.*

197 The requirements are included in the Nordic Data Protection Acts and Marketing Practices Acts.

membership bonus is offered as a free gift which is thrown in as a kind of benefit on the side. It was mentioned in Part III c that the Danish, Norwegian and Finnish Marketing Practices Acts all contain very similar *prohibitions* against the offer and advertisement of collateral gifts. From the Danish provisions in the Danish Marketing Practices Act, section 6, it can be deduced that frequent flyer programmes are categorized as loyalty programmes in which the bonus offered is a collateral gift and in principle prohibited. The Danish Parliament had to introduce express provisions to exempt FFPs from the general prohibition against collateral gifts for reasons of competition, as discussed in Part III c. This section also pointed out that the new Swedish Marketing Practices Act does not prohibit collateral gifts but imposes an information duty on businesses offering collateral gifts, according to which the conditions of the offer, its nature and value and any time limits and other limitations which apply must be stated very clearly by the business offering them. In Denmark, Norway, Sweden and Finland the Consumer Ombudsmen have agreed to issue guidelines to loyalty programmes offered by, for example, supermarket and other shopping chains, oil companies and airline companies. The guidelines were published in June 1997 and are also referred to in Part III.

B. The special features of FFPs

There are, however, special features about FFPs which distinguish them from ordinary loyalty programmes. Perhaps these features do not manifest themselves so strongly on the American market, where the consumer has a greater variety of choice between airlines, even though the market is dominated by a handful of the so-called *mega-carriers*. In Europe - despite liberalization and the application of the competition provisions in the EC Treaty - there is only limited choice for the consumer - at least if he or she is flying between countries in Europe. Here many routes are still mono- or duopolized, and it is very difficult to choose an airline that does not have a frequent flyer programme. In other words, *customers are to a certain extent forced to fly with airlines which feature FFPs*, despite the fact that the customer himself may not want to become a member.[198] In marketing law, it is generally regarded as a negative feature, if customers are more or less forced to deal with a business which operates a loyalty programme. This is the case where a supermarket chain is the only shop in an isolated rural area which sells the daily necessities and this supermarket chain features a loyalty programme. A close parallel is the situation where a customer has a choice between two airlines only, both of which feature loyalty programmes. Closely connected with this aspect of FFPs is the fact that once customers have become members, they become *tied to the airline* to whose FFP they belong in the sense that they now have the option of maximizing their benefits by concentrating all their flying on this single airline. In other words, something akin to an economy of scale is created on the demand side for the customer, who will want to continue to accumulate miles or points by flying with this particular airline.[199] This mechanism is strengthened if the airline FFP has fixed thresholds before a member can start to redeem

198 Verchère, Ian, *op. cit.*, 1997, p. 28, argues: ... *frequent flyer programmes are becoming just another airline technique for exploiting Europe's long-suffering consumer and reinforcing outrageous monopolies*.

199 Levine, Michael E., *op. cit.*, p. 419, defines *economies of scale* as referring to any advantages resulting from the gross size of the airline in number of planes or flights or some other convenient measure. If the airline serves destinations for both business and leisure purposes the effect will be more marked, because the business traveller can redeem points for travel to attractive holiday destinations.

points and rules according to which saved-up points must be redeemed before the expiry of a time limit (see Part I B).

Another notable feature of frequent flyer programmes is that they *obscure the price of flight tickets*. This is certainly the case once all the airlines operate them. If the cost of running an FFP, which according to some estimates is high, has any influence on fare levels, then even non-members help to finance them. Airlines argue that the free bonus tickets help to occupy seats which would otherwise be empty on the flight.[200] That may be true, but there is still the administrative cost of running the FFP system, which has to be financed somehow.[201] Furthermore, mileages or points are never fixed by money value, as shown in Part I C. As bonus points or mileages are unrelated to any cash value, it is practically impossible for the consumers to estimate the value of their point or mileage savings and consequently also to estimate the price of the actual flight. This fact was illustrated by the table *Carrier's Point Value* in Part I C. This aspect of *lack of transparency* is the more serious, because frequent flyer programmes are operated not only in the US and Europe but also increasingly by the Asian airlines, so that their scope is rapidly becoming worldwide.

The American FFPs give the impression that they operate with fairly low thresholds, so that it is reasonably easy for a member to save up bonus points and obtain a free bonus flight to an attractive destination.[202] The European FFPs are different in the sense that members are obliged to fly very often in order to save up a sufficient number of bonus points. Furthermore, points may expire before they can be used. This was discussed in Part I **B**. It is also a characteristic not only of the European programmes but of all frequent flyer programmes that *they are aimed chiefly at the business traveller.* Few travellers who travel for private purposes travel sufficiently often to be able to save up enough points in order to obtain a free

200 Tretheway, Michael W. in Frequent Flyer Programs: Marketing Bonanza or Anti-competitive Tool?, *Proceedings of 24th annual meeting, Canadian Transportation Research Forum*, 1989, p. 437, says: *If the airline was successful in confining the frequent flyer to otherwise empty seats and if these seats could be filled with no incremental cost to the airline, then perhaps there is some form of social benefit accruing here. Of course, these two assumptions are not likely to be true. Many of us have personal experiences of being unable to get on to a fully booked flight, only to learn later that many seats were occupied by airline employees or frequent flyer award users... Thus a certain proportion of the time, at the very least, airline frequent flyer award winners are likely to displace paying passengers. This creates an opportunity cost for the airline in terms of foregone revenues when it accommodates frequent flyer passengers*.

201 According to Mark Uncles, *op. cit.*, p. 19: *Costs [of running loyalty programmes] include promotional items, investment in building and maintaining databases, the expense of answering hundreds of inquiries, and the opportunity cost of management time. Even the relatively straightforward schemes that are operated by petrol retailers run into millions of pounds... Additionally, there is the problem of how customers perceive the costs: Aren't we paying for all these so-called freebies; wouldn't we rather pay less for the product itself?* Nick Barker and Gary Mason, *op. cit.*, p. 220, report that: *... initial establishment costs [of FFPs] were estimated to range between US$2 and US$12 million and the administrative resources to maintain these systems in postage alone amount to millions of dollars*. M. Durande, *op. cit.*, p. 6, mentions: *... In one of its studies, the British Civil Aviation Authority concluded that although FFPs are not cheap to establish or to operate, suggestions that they increase airline costs by 10 to 15% may be somewhat exaggerated*.

202 Mason, Gary and Nick Barker, *op. cit.*, p. 221, quote one US traveller going first class to Disneyland, taking two return trips to Australia and Hong Kong, three flights to Europe and still having 500 000 unused rewards.

ticket.[203] It is a fact that over two-thirds of airline revenues come from business travellers, i.e. travellers for whom the ticket is paid by the employer. These passengers may well view the frequent flyer bonus as something for nothing. However, the purchaser of the ticket, namely the employer, is not receiving the discount. The discount, namely the free air ticket, accrues to the individual traveller. Economists refer to this as the principal-agent problem. Agents, i.e. employees travelling on tickets paid for by their employers, usually make the decision as to the quantity, price and choice of carrier, and receive the benefits of the frequent flyer programme. The principal, i.e. the employer paying for the ticket, pays the cost but is unable to optimize air travel purchases since the decision is being made by the agent. It seems unacceptable that business travellers who do not pay for their tickets may arrange their travel so as to get the maximum number of bonus points while their company pays.[204] Another aspect of this problem is that airline FFPs - as mentioned above - favour the passengers paying the highest fares as they give better frequent flyer awards to such passengers. Although employers would prefer their travelling employees to buy the lowest fare possible, the employee is less price conscious because the higher the fare, the better the award.[205]

Once all the major airlines have established or participated in frequent flyer programmes, the net effect of the programmes has been to diminish their effect in attracting customers. While increased consumer loyalty has allowed each carrier to hold on to its own programme members, the same process has made it more difficult for carriers to attract passengers from competing airlines. From being instruments of competition, frequent flyer programmes have developed into marketing initiatives which an airline is more or less obliged to operate, if it wants to succeed on the market. While most airlines would like to abandon or phase out their programmes, no carrier can afford to do so.[206]

All these features concern primarily the marketing aspects of FFPs and their influence on consumer choice. Another very important aspect of FFPs is their effect on competition on the air transport market in relation to their possible role as entry barrier for new airlines. As

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203 It was mentioned in Part I B that, for example, British Airways does not credit the mileage if the member books the cheapest fare on economy class. The BA terms and conditions do not make this clear, see note 23.

204 Tretheway, Michael W., refers to this, *op. cit.*, on p. 433. Humphries, B.K., *op. cit.*, also remarks on p. 12 that *... frequent flyer programmes actually encourage passengers to trade-up to higher fare levels than they might otherwise use and even to undertake unnecessary travel*. Mason, Gary and Nick Barker, *op. cit.*, p. 221, make the same point: *One survey suggests that regular travellers change 10% of their itineraries to benefit from particular FFPs and a travel agent is cited as quoting a fare of US$1000 cheaper which was refused by the passenger in favour of an alternative carrier offering a better air miles deal. In the United States, over 80% of travel agents reported that their business customers choose flights to accumulate additional frequent flyer miles in more than half the flight decisions they make*. Beaver, Allan, *op. cit.*, p. 48, does not agree. He says: *... the evidence that travellers may be disregarding corporate travel policies in order to gain personally may be dismissed as anecdotal*. He quotes a survey according to which frequent flyer programmes distort travel plans in only 10% of trips.

205 Other factors in choosing fare levels or class to be flown are also that the lower fares may only be available on discriminatory terms and are usually capacity controlled by the airline. Thus the lower fare may in fact not be available or suitable for the employee's travel plans. See Levine, Michael E., *op. cit.*, p. 453.

206 Beaver, Allan, *op. cit.*, p. 45, argues *... that customer loyalty schemes are becoming a cost which cannot be avoided without losing business, rather than a marketing concept*.

discussed in Part III B, the European Commission does not consider *FFPs as such to be anticompetitive*, but in the case of *alliances or mergers, the Commission regards FFPs as a potential barrier to entry for new smaller, competing airlines* (in the same way as it does the limited availability of slots). Accordingly, FFPs may unduly strengthen the dominant position of the merging airlines and may thus represent an abuse of the merging airlines' dominant position. The merging airlines have therefore been required by the Commission to offer to those competitors who do not directly or indirectly participate in a frequent flyer programme the opportunity to participate in their FFP under reasonable and non-discriminatory financial conditions. The problem of the anticompetitiveness of frequent flyer programmes was discussed in Part III B, and it remains a problem to be solved - even though the commission takes the view that FFPs as such do not infringe Article 86.[207]

The overall picture is that frequent flyer programmes are powerful marketing initiatives. It is doubtful if the argument that they lose their effectiveness once all the major airlines operate them is true. Without doubt they enable the major airlines to keep smaller, new airlines at bay. Michael Tretheway argues that FFPs raise the costs to rivals as follows:

> *Consider an airline customer located in Toronto. This business traveller makes trips to various destinations in North America during the year. If Airline A flies to most of these destinations, then it will be easy for that customer to accumulate frequent flyer points. Airline B, on the other hand, might only fly to a limited number of the customer's destinations. Even if the customer always chose Airline B for those destinations, it would be very difficult to accumulate a large number of points. Thus, in choosing between Airline A and Airline B for a trip to a destination served by both, the customer is likely to choose Airline A if the payout ratio is the same for both carriers. A marginal trip on A is more likely to bring the customer to a given mileage level necessary for a particular reward. This is especially important given the accelerating nature of rewards as mileages accrued. To counter this disadvantage, Airline B must offer a more generous reward payout. This of course raises Airline B's cost.*[208]

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207 The situation in Europe in this sphere in 1997 is described in detail by Verchère, Ian, *op. cit.*, 1997, pp. 28-36, as discussed in Part III B.

208 Tretheway, Michael, *op. cit.*, p. 441. Tretheway and other economists writing in this area base their argument on the thinking of Cairns, R. and J. Galbraith (for example in their article: Artificial Compatibility, Barriers to Entry, and Frequent Flyer Programmes in *Canadian Journal of Economics*, November 1990, pp. 807-816). Cairns and Galbraith make the point that it is difficult for a new entrant airline to attract passengers unless the airline establishes its own programme or participates in another carrier's, all of which create extra entry costs for the new airline. If the established airline has a comprehensive network, passengers prefer to participate in the FFP of the established airline rather than in that of the new entrant with only a limited route network. Furthermore, FFPs build barriers to entry on the demand side of the market by creating artificial linkages of demands for different services. This is because a relationship is created by virtue of the FFP between otherwise unrelated goods or services, so that the purchase of two products from the same airline becomes advantageous when it would not otherwise have been so.

Furthermore, the cost of running FFPs is likely to have an influence on the cost of fares. FFPs are contributing factors towards making it very difficult for the customer to find out what he is really paying for his ticket. In Europe, with its mono- or duopolized air transport market, customers have limited possibilities of choosing an airline which does not feature an FFP. There is the ethical aspect of their being chiefly aimed at business travellers who do not pay their own fares and who may choose costly flights to save up bonus points at the employer's expense. Another issue is that passengers who fly for their own private purposes become *second rate passengers* in the sense that they do not fly enough to benefit from membership of an FFP.

Mark A. Johnson sums up the negative effects of FFPs as follows:

> *FFPs appear to be calculated to deter consumers from selecting freely at any time in the light of the market situation the most favourable of the offers made by competitor airlines and to prevent them changing supplier without suffering an economic disadvantage. They therefore limit the consumer's choice of supplier and make access to the market for air transport difficult for competitors. They affect the maintenance of competition already existing in the market by their propensity to raise rivals' costs. This may occur through a number of factors: firstly, airlines with smaller route networks who operate an FFP are forced to set a higher pay-out ratio to compete with the FFPs of larger airlines; secondly, FFPs give their operators a revenue advantage because of their ability to tie in high yield passengers, especially business travellers; thirdly, small airlines which cannot afford to operate their own FFPs are forced to pay high fees if they wish to participate in a larger airline's scheme.*[209]

There seems to be a case for either prohibiting frequent flyer programmes completely or for regulating them. The question is: which of the two solutions should be chosen and, if the second is chosen, how should FFPs be regulated? These questions are considered below. In relation to the principal-agent problem, is there a possibility of taxing frequent flyer awards? If this is considered to be a viable solution, the question arises of how this should be done. This will be discussed in section D.

C. Regulating FFPs

The first question is: *Should frequent flyer programmes be prohibited?* As already discussed above in part III C, frequent flyer programmes - as collateral gifts - were originally prohibited in the Danish Marketing Practices Act, but in 1992 the Danish Parliament was forced to exempt FFPs from the prohibition. Accordingly, the Danish Consumer Ombudsman has adopted the position that, since the Danish Parliament has allowed FFPs, he is unable to do

209 Johnson, Mark A., Removing Barriers to Market Entry in the Air Transport Industry: The Application of EC Competition Rules in *Legal Issues of European Integration*, 1993, Vol. 2, pp. 13-14.

anything about them. The decisive argument in 1992 for amending the Danish Marketing Practices Act and allowing SAS to operate a frequent flyer programme was that the existing prohibition prevented SAS from competing on an equal basis with the international airline companies, all of which operated FFPs. Thus it does not seem a viable solution to require Denmark, or the Scandinavian countries - or any of the member states of the European Community for that matter - to prohibit them at the national level. Nor is it a viable solution to prohibit them at the EC level. This would only harm the European airlines in their efforts to compete on the world market. So the answer to the first question is: *No, FFPs probably cannot be prohibited or ended successfully.*[210] Michael W. Tretheway, when writing about frequent flyer programmes in Canada, reached exactly the same conclusion for the North American market. He writes:

> *Is it possible to end frequent flyer programs? Certainly an individual carrier cannot unilaterally end the program. Since they are effective in building brand loyalty, its customers would very rapidly switch to other airlines where their loyalty would be rewarded. … Ending the frequent flyer programs would require a decision by the industry as a whole. This would be difficult for the industry to initiate without appearing to violate various aspects of anticompetitive legislation. One possibility would be for the national government to intervene and either allow the airlines to negotiate an end to the deals or to use its regulatory authority to directly end the programs. It would be difficult for Canada to end the programs by itself. Indeed, frequent flyer programs were introduced in Canada in order to remain competitive with U.S. carriers serving transborder markets. Thus, a government initiative to end frequent flyer programs will require North American-wide cooperation*[211]

Given that it is not a viable solution to end frequent flyer programmes by prohibiting them, the second question is: *Should they be regulated?* As shown above, FFPs do have negative marketing effects seen from *the consumer perspective*. They deprive customers of freedom of choice, customers become tied to the airline, the programmes obscure the price of flight tickets, and passengers are divided into classes. Seen from the perspective of *competition between airlines*, FFPs create difficulties of access to the market of air transport for new entrant airlines. They affect competition between airlines already in the market because 1) they

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210 The only possible way of prohibiting FFPs successfully now that they have spread from the US to Europe to the Far East would be to do so on a global basis. The basis exists: it could be done by the World Trade Organization. The author of this paper would prefer this solution if it could be done so that frequent flyer programmes were prohibited as a marketing initiative.

211 Tretheway, Michael W., *op. cit.*,p. 445. He regards FFPs as undesirable as they lower society's overall state of well-being. He says: *While individual travellers receive benefits of free airline tickets, these have been earned in many cases by unnecessary travel at an employer's expense. Consumers ultimately pay for any increase in ticket prices due to frequent flyer programs and any increases in prices of other goods due to higher corporate travel budgets. The frequent flyer programs are anti-competitive in nature, as they favour large air carriers even when there are no economies associated with larger airline operations. The programs are a means to raise rivals' costs and act as a very effective entry barrier to the airline industry. Since frequent flyer programs act as an unnecessary barrier to entry to the airline industry, and since they lead to unnecessary travel, society will be better off if these programs are terminated*. (*Ibid*.)

tend to raise rivals' costs, 2) they force airlines with smaller route networks to set a higher pay-out ratio to compete with the established airlines, 3) they force small airlines who cannot run their own FFPs to pay high fees when participating in the programmes of the established airlines. These aspects, referred to above in section **B**, indicate that regulation is called for in some form or other, so the answer to this question is: *Yes, they should be regulated.* Once this question is answered, two more follow: how should the regulation be carried out? - always assuming that regulation is carried out not at the national but at the EC level; and what should be the content of such regulation?

The third question is then: *How should frequent flyer programmes be regulated?* What form should such legislation take? The regulation of the marketing of FFPs does not seem to lend itself easily to regulation by *hard laws*, i.e. binding EC legislation. This applies to many areas where new legislation has to be made without the possibility of drawing on past legislative experience in the area in question. In recent years, the EC has made increasing use of *soft laws*. These laws may take forms such as non-binding recommendations, memoranda and codes of practice. The solution of adopting a code of conduct for FFPs has the advantage of flexibility and offers the possibility of gradual adjustment as experience of regulation in the area is gained. It is also a solution which can be adopted in the US according to the - perhaps different - needs of the US air transport market in the area of FFPs and two such codes, an American and a European may form the basis of negotiations for overall regulation in the West.[212] The answer to the third question is thus: *An EC Code of Conduct for FFPs should be elaborated by the Commission along the same lines as the EC Code of Conduct for CRSs - but at least to begin with - of a non-binding nature.*

The fourth question is: *What should be the content of a Code of Conduct for FFPs?* Scandinavian marketing law contains some generally - i.e. in the whole of Scandinavia - accepted principles which could profitably be adapted and form the basis for the regulation of frequent flyer programmes at EC level. The acceptance of these principles is universal in the Scandinavian countries, and the principles set a very high standard of conduct. It is often surprising to find that they are not as readily accepted by, for example, American marketing researchers. In the EC, in the area of marketing, access to the market and consumer protection, the principles embodied in Scandinavian marketing law are often used as patterns for EC legislation.[213] The principles of Scandinavian marketing law can also be taken as the

212 In the EC in the area of air transport, a Code of Conduct for CRSs, which was referred to in Part III B**,** was introduced in 1989 and amended in 1993. This Code is mandatory. An American code of practice for CRSs was adopted in 1984 and amended in 1992. Negotiations - initiated because the American code discriminated against third countries - were initiated by the European Commission with the US Department of Transportation. The negotiations resulted in an amendment of the American rules. This was described in note 174 above.

213 EC legislation for consumer protection in the areas of adjustment of unreasonable contract terms, doorstep selling and consumer sale of goods contracts has a Scandinavian origin. The European Community formulated its first consumer protection and information programme in 1973. The proposals for this programme were elaborated by the European Commission during the period of the Danish presidency in the Council and were passed by the Council in 1975.

pattern for the proposed Code of Conduct for frequent flyer programmes. Accordingly, the Code should be based on the following principles:

- A basic principle of Scandinavian marketing law is that any person or company carrying out a business or trade may not act in contravention of the legal standard of *good marketing practice*.[214] The standard of good marketing practice applies to the behaviour of businesses, not only in their relationship with consumers, but also between businesses when they compete with one another in the market. Similarly, it is a fundamental principle of Scandinavian marketing law that incorrect, misleading or unreasonably inadequate information - chiefly in the form of advertising - may not be used for marketing purposes.[215] The principle of transparency is reflected in the obligation imposed on all retailers to clearly indicate the price of the goods or services offered for sale. The proposed Code should require of airline companies that they observe good marketing practice both in their relationship with their consumers and in their mutual competition when they operate FFPs. Incorrect, misleading or unreasonably inadequate advertising of FFPs should be avoided by airline companies. A general duty of clarity in price advertising should be introduced.

In the following, some more detailed suggestions about the content of the proposed Code will be put forward according to this pattern: a problem posed by frequent flyer programmes will be identified briefly, followed by the proposal of a solution to the problem by the introduction of a rule in the Code.

- It is a problem that *the general FFP marketing material*, *the brochures* and *the membership conditions* are often insufficient and obscure. To solve this problem the Code should require that all *descriptive material* published or issued by the airline in connection with the marketing of the programme is legible, understandable and accurate, providing a reasonable decision-making basis for the consumer. Brochures should be required to contain adequate information concerning 1) conditions of membership; 2) the information which the member is required to give to the airline on applying for membership; 3) general information on the bonus system itself; 4) information about the types of bookings and the classes of flights on which bonus savings can be made and information about how

214 The requirement that businesses must act in accordance with *good marketing practice* is embodied in the Danish Marketing Practices Act of 1994, section 1. The Act is based on the principle that the Consumer Ombudsman supervises that businesses do not infringe the Act by bad marketing practice. The Norwegian Control of Marketing Practices and Contract Terms Act of 1997 contains the same legal standard in its section 1. The Swedish Marketing Practices Act of 1995 defines good marketing practice in its section 3. Finland and Iceland have similar provisions in their Consumer Protection Act and Competition Act, respectively.

215 This requirement concerning truth in advertising is in section 2 of both the Danish and the Norwegian Practices Acts. The Swedish Marketing Practices Act prohibits misleading advertising in its section 6 and refers to five different types of misleading advertising. The Finnish Consumer Protection Act No. 38 of 20 January 1978 contains the general rule on advertising in its chapter 2, section 2. It has detailed rules for advertising in connection with sales and price reductions. In the Icelandic Competition Act No. 8/1993, the rules on advertising are contained in section 21.

bonus savings are graded; 5) information about the various types of bonuses such as *free* flights, hotel stays, car rental and other types of bonuses, for example gifts in the form of luxury goods, cruises or sports facilities; 6) other advantages connected with membership such as waiting list priorities, access to airport lounges, extra baggage allowances, flight upgrade possibilities, express check-in and recognition of status as a frequent flier (e.g. *silver* or *gold* membership levels); 7) the minimum level of bonus savings required before savings can be redeemed; 8) the minimum amount of bonus savings required in order to obtain a free flight or any other type of benefit in the programme; 9) time limits within which bonus savings must be redeemed and information about expiry of bonus savings, blackout periods, etc; 10) advantages connected with the use of payment cards such as an American Express or a Diners' Club card. Furthermore, the Code must require airline companies to provide consumers who wish to enrol in the programme with transparent information about *terms and conditions for membership* before or in connection with enrolment, in particular written information as referred to above in 1)-10) enabling members to calculate the value of their bonus savings, so that members can determine what they are actually paying for the ticket.

- It is a problem that *FFPs tie customers to the airline* as a consequence of their membership of the programme. Their critical sense and freedom of choice become illusory as their attention is diverted away from what they were out to buy in the first place, namely air transport, and becomes fixed on perks and freebies, the value of which they have no means of ascertaining. Customers are unable to calculate what they are actually paying for the ticket which they are buying, as the bonus in the existing programmes is not made up in money value and may even ostensibly be offered for *free*. To remedy these problems the Code should require that bonus savings should be made up in cash value by the airline. Programmes which make use of differentiated and progressive bonus savings should not be allowed. If minimum levels of savings are fixed before the bonus can be redeemed, the level fixed should be reasonably low. The differentiation of bonus according to class travelled should be abolished, so that bonus savings accrue on all types of flights regardless of class. Members should be given the option of redeeming their savings in cash after a certain period of membership. Programmes should not contain rules for blackout periods, so that bonus savings can be redeemed as soon as the member has saved up a certain minimum amount. The complicated bonus tables should be drastically simplified and indeed the right to alter and vary the terms and conditions of the programmes at the airline's total discretion, which the airlines now reserve for themselves, should be curtailed. Those advantages connected with membership of the programme which are not proper price advantages but advantages connected with a certain status, e.g. access to airport lounges, express check-ins and the like, should be made available to customers who are not members for a certain price.

- It is a problem that FFPs are *anticompetitive* as some - particularly the bigger, established airlines - are able to market their programmes at a lower incremental cost than their smaller competitors. In particular, carriers offering flights to a large number of

destinations are likely to have lower FFP costs than smaller carriers. It is easier for customers to accumulate points on carriers serving a large number of destinations, and the small carriers must counter this by more generous payout ratios. The net effect is to create forces in the market place which favour the large carriers. Cairns and Galbraith view FFPs as creating artificial compatibilities between totally disjointed airline trips which act as a barrier of entry into the airline industry. A solution to the problem of anticompetitiveness would be for the Code to require smaller or weaker carriers to be allowed to participate in the FFPs of the bigger carriers. The Code should also prohibit carriers from distorting market forces through over-generous bonus awards on selected routes. A more radical solution, which was considered in the US, would be to allow FFP bonus awards to become negotiable and/or interchangeable between individuals via brokers.[216] An even more radical proposal would require airlines to honour bonus miles earned on other carriers even though this constitutes a disadvantage for those airlines with route networks which include the more desirable holiday destinations.[217]

- It is a problem that frequent flyer programmes constitute a *permanent liability* for all airlines - big or small - as unredeemed bonus savings accrue with each airline. As B. K. Humphries puts it: *One of these [risks] is the amount of free travel now owed to programme members in the US. According to one estimate, this amounts to some 15 million round-trip tickets.*[218] Allan Beaver gives an estimate of the extent of the problem on the European market as follows: *Only half of European business travellers have actually redeemed their awards, although 97 per cent state that they intend to at some time in the future*.[219] A solution to this problem would be to require airlines to declare this liability of outstanding FFP points on their balance sheets. This would be a good way of controlling them. A. V. Seaton and M. M. Bennett put it as follows: *However, like any innovation, FFPs have not been without problems. For the airlines involved, one such problem is the amount of FFP mileage accrued that has not been redeemed. This is known as contingent liability. While it is acknowledged that redemption of FFPs on low-load flights will minimize revenue dilution, on a busy or full flight the result is very different... Currently, there is no legal requirement for this liability to be declared on the balance sheet. Should the law change then the future of FFPs could be brought into question.*[220]

If airline companies were required to live up to these standards of practice in devising their frequent flyer programmes, the programmes would undoubtedly lose a good deal of their attraction. This result would be desirable in the long run, and the customers would be enabled

216 Verchère, Ian, *op. cit.*, 1993, p. 18.
217 Humphries, B.K., *op. cit.*, p. 14 and Levine, Michael E., *op. cit.*, p. 453.
218 Humphries, B.K., *op. cit.*, p. 14.
219 Beaver, Allan, *op. cit.*, p. 46.
220 Seaton, A.V. and M.M. Bennett, *op. cit.*, p. 388. The problem is the more serious as, for example, American Express takes frequent flyer points from any airline and converts them into the credit card company's permanent, ongoing point system. American Express does not give full point value, but on the other hand there is no time limit for redeeming saved-up points and this is certainly a permanent liability for the airline.

to make better and more rational choices when buying airline transport. As mentioned before, many travellers are in favour of FFPs, others consider FFPs to be rather unimportant compared with the restrictions imposed by airline mergers, slot control at airports and state aid.[221] But in fact, FFPs may be a far more important item in the generally very opaque market of air transport. The market might profit more than one might immediately think if FFPs were regulated and curtailed as suggested above. A good deal of the reluctance to regulate them might possibly stem from the fact that the influence and effect of FFPs on choices made by customers and the undesirable distortion of choices which results from that, have not been fully appreciated or acknowledged. The introduction of a Code of Conduct for frequent flyer programmes would undoubtedly bring about a desirable change in the long term, and it is to be hoped that the Commission not only agrees with this, but will also prove willing to do something about it.

D. The principal-agent problem. Should FFPs be taxed?

It was argued in the preceding sections - from the point of view of consumers generally - that FFPs are undesirable in that they lower society's state of well-being. It was suggested that they should be curtailed and regulated - if only by *soft law*, i.e. by a code of conduct. In this section, attention will be focussed on a particular aspect of FFPs, namely the ethical aspect that business travellers obtain the bonus savings for their own, private use on account of travel undertaken on behalf of their employer and for which their employers have paid. Quite apart from the temptation that business travellers organize their flight on the basis of their membership of the FFP, this aspect makes a strong case for classifying FFP bonuses as a taxable benefit. Michael W. Tretheway, writing about the Canadian FFP market, has formulated the problem as follows:

> *While individual travellers receive benefits of free airline tickets, these have been earned in many cases by unnecessary travel at an employer's expense. Consumers ultimately pay for any increase in ticket prices due to frequent flyer programs and any increases in prices of other goods due to higher corporate travel budgets... since they [FFPs] lead to unnecessary travel, society will be better off, if these programs are terminated... Another avenue to assist in consumer acceptance of the end of these programmes is to actively tax them. When faced with going out of pocket for taxes due on "free" trips for the family to Europe or the Orient, the consumer may well decide to pass.*[222]

221 Havel, Brian F. points to yet another economic challenge that faces the large airline companies after deregulation, namely the susceptibility of passengers to the appeal of price reduction. The passengers in this category are not the business travellers who weigh frequency/convenience parameters above price, but passengers who travel at their own expense for leisure purposes. As Havel says in his book *In Search of Open Skies: Law and Policy for a New Era in International Aviation*, Kluwer Law International, Dordrecht, 1997: *Despite the clever marketing rules of frequent flyer programs, a certain "commodification" of airline travel has developed. Whether on domestic or international routes, American Airlines President Robert Crandall testified to the airline commission, [airlines] have to match whatever price is offered by anybody else*.

222 Tretheway, Michael W., *op. cit.*, pp. 445-446.

Sir Robert McCrindle writing about frequent flyer programmes in the United Kingdom puts forward the following prognosis:

> *Frequent flyer rewards have been the target of criticism for years. Nevertheless, executive passengers value few perks above the opportunity to earn free travel... [But] only a bold man would bet on the perks society remaining sacrosanct. Given what has happened with company cars, taxing airline and hotel loyalty schemes could well be on the cards.*[223]

It must, of course, be kept in mind that there are other reasons for business travellers to travel business class than their membership of a frequent flyer programme. Sometimes they cannot choose the cheapest flight because these are already fully booked or because the time of departure is inconvenient for the traveller's purposes. Cheap tickets on economy class are always inconvenient in the sense that they have to be booked in advance and the booking once made cannot be altered. It must also be taken into consideration that business travel is not always agreeable, and the employer may accept the employee's FFP membership as a form of compensation for the inconveniences caused by the travel. Michael E. Levine writes as follows:

> *Airlines give better frequent flyer awards to passengers paying higher fares. Although the principal [employer] would prefer the agent [employee] to buy the lowest fare possible, determining whether a low fare available on discriminatory terms and capacity-controlled by the airline was in fact available and suitable for the employee's travel plans can be very difficult and also intrusive in a way that is costly to morale.*[224]

On the whole, however, Levine - and most other authors with him, the present author included - consider that there is a justification for regulatory intervention - if not by banning FFPs completely then by requiring travellers who receive frequent flyer benefits on tickets they did not pay for themselves to report the bonus as a taxable benefit of employment. The imposition of such a duty would serve to limit the employee's benefit from choosing flights on the basis of his membership of an FFP, and would be in accordance with standard tax policy.[225]

A number of problems are associated with this solution - simple though it appears to be. 1) If the solution is to be effective, only bonuses obtained by business travellers should be taxable. Bonuses obtained by travellers who travel for their own private purposes on tickets for which they have themselves paid (i.e. tickets purchased exclusively with after-tax income) should

223 McCrindle, Sir Robert, Points of View - Opinion, *Executive Travel*, March 1997, p. 16.
224 Levine, Michael E., *op. cit.*, pp. 453-454.
225 Levine, Michael E., *op. cit.*, p. 491.

not, of course, be taxable, just as buyers in a supermarket cannot be required to pay tax on price reductions or discounts on the purchases they make there. For the solution to be viable, a *distinction between* FFP awards earned on tickets purchased with income after tax *and* awards earned on business travel paid for by the employer should be made. The problem could be solved by taxing all FFP members who have redeemed their points and obtained free bonus travel within a year. Instead of making it the duty of the individual traveller to report free bonus travel to the tax authorities, the airlines should be required to provide a list to the tax authorities of all those who have received free bonus travel within a year, with a copy of the statement sent to the traveller. The onus would then be on the taxpayer to provide appropriate evidence to the government that an FFP award is not taxable. Thus frequent flyer benefits could be declared taxable unless the taxpayer provides evidence, such as receipts for the tickets, that points or bonus savings were earned with after-tax income.[226] In practice, this would involve taxation of all free bonus travel. Taxpayers who were able to prove that the bonus savings were made with after-tax income would then receive a refund.[227] 2) Accruing bonus points is not the same as using them. What is the value for taxation purposes of a benefit which has numerous restrictions on when and how it can be used? Similarly, the value will vary according to the destinations chosen and the fare structure in effect at the time. Furthermore, is the value of the benefit equal to the level of the equivalent public fare which the passenger would have had to buy in order to travel to the same destination or to the actual cost to the airline of carrying him, which for a capacity-controlled product would be considerably less? This problem cannot be solved satisfactorily without, so to speak, cutting the Gordian knot. But before this can be done, one essential condition must be fulfilled: bonus savings must be made up in cash value - as already proposed above in section C in connection with the code of conduct. Furthermore, revenue authorities would need to decide in advance in their relevant tax provisions whether bonus savings should be taxed at their full value at redemption or if taxation should be based on a percentage of this, namely an amount which the FFP member could be expected in normal conditions to spend out of his own income on comparable travel. 3) The international character of the frequent flyer schemes complicates the matter. The EC Commission is granted no powers to introduce a proposal with the content suggested above of taxing *free* frequent flyer bonus travel, as this concerns the taxation of individual taxpayers in the member states, a question which is reserved for the exclusive authority of the national governments of the member states. In other words, the problem must

226 The tax provisions in Denmark at present in force - as shown in Part I B - lay down that free bonus travel for points accumulated while travelling on business is liable to be taxed. It is a duty for persons who have travelled on business and have accumulated bonus points to inform the Danish tax authorities in their annual tax report that they have redeemed their bonus savings for the purposes of private travel. In Sweden, the employee must report to the employer, when redeeming bonus points for private travel, if the firm has paid for the travel. The employer must subsequently report this to the Swedish tax authorities. Above, in note 21, it was briefly described how some of the FFP terms and conditions, namely those which refer to the question at all, have dealt with it - mainly by making any question in connection with a tax liability the responsibility of the member exclusively and certainly not of the airline.

227 A somewhat similar solution would be to require airlines to accrue frequent flyer benefits to the person or company actually paying for the ticket. As discussed in Part I, Maersk Air and Air France do this. This solution may, however, create more problems than it solves, mainly because many business trips are booked through travel agencies. If the firm is so large that it has its own travel department, it would surely need extra staff to administer and use the bonus savings, which is complicated enough in its own right.

be addressed by each member state, if a solution of direct taxation of the individual taxpayer is chosen. The problems which such a solution will give rise to were indicated in part I **B**. As referred to there, SAS strongly opposed a proposal according to which they should report redemption of points and bonus travel to the Danish tax authorities. SAS argued that it would give competing airlines an unfair competition advantage, unless of course a similar duty were to be imposed on the other airlines operating in Denmark. In theory, this would be possible but in practice it is not, because how could such a duty be enforced against airlines such as British Airways, which keeps all the administration of its FFP in the UK? Another and more feasible solution would be to regard taxation of FFP travel as indirect taxation, i.e. as a charge on service. In this case the Commission could put forward a proposal for harmonization of indirect taxation, because it would be necessary to ensure the establishment and the functioning of the internal market in this area under Article 99 of the EC Treaty, as amended by Article G(20) of the Treaty of the European Union. Such a proposal from the Commission must be adopted by a unanimous vote in the Council after consultation with the European Parliament and the Economic and Social Committee.

Undoubtedly, the whole problem of regulating frequent flyer programmes is a knotty one, and no easy solution is available. Part of the problem results from the fact that it is rapidly becoming a global phenomenon. Perhaps another part of it stems from the fact that it is only dimly realized how damaging to the whole area of air transport the programmes really are. In what other area would marketing initiatives with the power they have over consumer choices, their obscuring effect on price transparency, the unethical effect on business travel, the way in which - if uncurbed - they may be used to keep new smaller airlines out of the market, all of which frequent flyer programmes undoubtedly do, be tolerated? Hopefully something will be done to regulate them, and hopefully this paper represents a step in that direction.

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