



## After the *Airtours* Appeal

The forensic demolition by the Court of First Instance of the Commission's decision to block the proposed merger of Airtours and First Choice in 1999 will be seen as a watershed in EU merger policy.<sup>1</sup> The Court accepted virtually all Airtours' arguments and was severe in its criticisms of the Commission's analysis, concluding that the decision was 'vitiating by a series of errors of assessment'. For future EU mergers, the most significant aspect of the judgment is the clear guidance it gives for the assessment of mergers in oligopolistic markets.

### Clarification of the test

The judgment makes it unambiguously clear that collective dominance involves an assessment of tacit coordination. This had always been Airtours' position and a key part of its appeal was that the Commission had departed from its previous approach to collective dominance.<sup>2</sup> The Court sets out three necessary conditions.

- First, the market must be sufficiently transparent for each member of the oligopoly to monitor the behaviour of other members in order to gauge whether or not they are adhering to the tacitly agreed 'common policy' of lowering output and raising prices.
- Second, a punishment mechanism is an essential part of ensuring that this 'common policy' is sustainable as there is a need to counter the incentive to 'cheat'.
- Third, it is also necessary to establish that the reaction of competitors and consumers would not undermine the benefits expected from the 'common policy' (which in this case primarily involved an assessment of barriers to entry).

In deciding whether to block a merger on the grounds of collective dominance, the Court stressed that the Commission must produce convincing evidence that all these conditions would be met.

The level of competition in the market at the time of notification was also viewed by the Court as a 'decisive factor' in establishing whether collective dominance would be created. In this regard, the Court described the Commission's description of pre-merger competition in the foreign package holiday (FPH) market as 'particularly elliptical' but noted that the Commission had not contended in its pleadings that there was collective dominance at the time of

notification. This meant that the Commission's task was to demonstrate the *creation*, rather than *strengthening*, of a collectively dominant position.

One of the Commission's key arguments relating to pre-merger competition was that the large companies were 'cautious' in setting capacity. The Court dismissed this as no more than the parties' 'right to adapt themselves intelligently to the existing and anticipated conduct of their competitors'. This was a highly significant finding, as one of Airtours' central arguments was that the Commission had confused 'acceptable' oligopolistic interaction with tacit coordination in the decision.

### The need for a punishment mechanism

The judgment also lays to rest once and for all the debate over the need for a punishment mechanism in the assessment of collective dominance. The decision adopted what the Court described as a 'somewhat ambiguous' approach, as it stated that the Commission did not regard 'a strict punishment mechanism' as a necessary condition, noting that where 'there are strong incentives to reduce competitive action, coercion may be unnecessary' but also stating that it believed there was scope for retaliation in the FPH market.<sup>3</sup> But the Court removes any doubt, confirming the consensus of economic theory that a credible punishment mechanism is an essential part of a sustainable policy of tacit coordination in order to counter the incentive individual firms have to 'cheat'.

The Court went systematically through each of the deterrents identified in the decision and concluded that none represented a credible punishment mechanism. Two observations made by the Court are particularly pertinent for the assessment of the credibility of retaliation in future cases. First, the Court found that the Commission was wrong in concluding that the mere possibility of reverting to a situation of oversupply (such as that which occurred in the FPH market in 1995 when demand was misjudged) would act as a deterrent. Second, the Court found that although the Commission need not necessarily demonstrate a specific retaliation mechanism involving a given degree of severity, it must nonetheless establish that sufficient deterrents exist. Taken together, these points provide insight into the required standard of proof in future cases: the Commission must show that a credible punishment mechanism exists, but it is not incumbent upon the Commission to describe in minute detail exactly how the postulated retaliation would operate. This seems

<sup>1</sup> Lexecon Ltd acted as economic advisors to Airtours in the original case and throughout the Appeal.

<sup>2</sup> For a more detailed discussion on this point, see our *Competition Memo* 'The Airtours Case', November 1999.

<sup>3</sup> See paragraphs 150 and 151 of the original decision.

a reasonable balance.

### Factual analysis in the *Airtours* case

During the Appeal procedure, *Airtours* argued that the original decision was a 'forced fit': the characteristics of the FPH market were not conducive to the establishment of tacit coordination. The Court clearly shared this view, and was sharply critical of the empirical and theoretical analysis undertaken by the Commission. Examples include:

- The Commission did not prove that the market was sufficiently transparent for the oligopolists to monitor capacity at the time that capacity decisions were taken.
- It was wrong to argue that mergers following the Monopolies and Mergers Commission (MMC) report in 1997 meant that the MMC's relatively positive findings on competition in the FPH market could be ignored.
- It erred in asserting that market shares resulting from acquisitions should not be taken into account and therefore that market shares were relatively stable.
- The analyses of demand growth and demand volatility were also fundamentally flawed.
- Finally, the Commission failed to give sufficient weight to the responses of fringe players and consumers to the postulated reduction in output and increase in prices.

The Court's tone was severe. For example, it found that the Commission had relied on a one page extract from an advertising agency document in finding that demand growth was 'quite low'. Examination of this document by the Court indicated that even a ' cursory examination' showed that the Commission's reading was 'inaccurate', given the emphasis in the document on the strong growth that had taken place.

The Court was equally damning of the Commission's interpretation of economic theory. For example, in the pleadings the Commission accepted *Airtours*' contention that economic theory showed that demand volatility makes tacit coordination more difficult by increasing 'noise' and thereby making cheating harder to detect, but argued that economic theory 'did not apply' in this case. This assertion was emphatically rejected by the Court.

The Court's exhaustive examination of the factual basis of the decision has major significance beyond issues associated with collective dominance. The Court has provided clear guidance on the standard of economic reasoning that should be applied in merger cases. Facts should be assessed carefully and related to the economic case being made.

### Implications for future cases

In the three years since the *Airtours* decision, the Commission's thinking on collective dominance has evolved and, in some cases, has become more

sophisticated. However, this evolution has not taken place in a systematic fashion and the Commission's stance in any given case has remained unpredictable.

On some occasions, the Commission's approach still involved a somewhat mechanistic application of the 'checklist' approach. If the Court's methodology is followed, such an approach is no longer tenable: the Commission must explain how checklist characteristics would facilitate tacit coordination. Although the Court's framework does not solve all the difficulties associated with predicting the likelihood of future coordination, it does at least clarify the meaning of collective dominance as a concept and it specifies the relevant avenues of investigation. As such, the clear test set out in the Court's judgment should provide a greater degree of predictability over how collective dominance is assessed and should result in a further (and welcome) move away from the mechanistic application of the 'checklist'.

Much will now depend on the Commission's response. Initial indications are not encouraging. The Commission has argued that the case shows that it is subject to stringent independent third party review. This ignores the three-year gap between the decision and the judgment. Most parties negotiating with the Commission will still take the view that immediate compromise (regardless of the merits of the Commission's case) to clear the deal is preferable to a somewhat pyrrhic victory three years later.

The new 'fast track' procedure is little better: this still involves a significant delay, is not automatically granted and requires significant limitations on the areas to be investigated by the Court. In this context, the debate over whether there should be a move away from a dominance-based test in EU merger control to one based on a US-style significant lessening of competition approach is something of a sideshow: it is more important to subject Commission decisions to a much more rapid third party appeals procedure. It is hard to reconcile the quality of the Commission's analysis in the *Airtours* case with the Commission's claim that its behaviour is significantly disciplined by the threat of a successful appeal.

### Conclusion

The overwhelming victory for *Airtours* (now MyTravel) may be of little immediate benefit to the company itself but the decision to appeal has brought wider benefits. First, the Court has clarified the test for collective dominance to such an extent that future cases should be more predictable. Second, the severity of the Court's judgment can only be interpreted as a 'wake-up call' to the Commission. Indeed, the significance of the judgment goes well beyond collective dominance. It underpins the need for the introduction of greater transparency and accountability of decision-making by the Commission.

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