

# CRA Competition Memo



## The *Airtours* case

The decision by the European Commission to block the acquisition of First Choice by Airtours in the UK foreign package holiday (FPH) market is a landmark case in European merger control.<sup>1</sup> With post-merger shares of 32% for Airtours/First Choice, 27% for Thomson and 20% for Thomas Cook, it confirms that the Commission is ready to block mergers in oligopolistic markets in which no single firm is dominant. However, in prohibiting the Airtours/First Choice merger the Commission did not rely on a coherent interpretation of collective dominance. As a result, the criteria for the assessment of mergers are less clear now than before. In this memo we explain the sources of confusion and suggest that the Commission needs to clarify its approach as a matter of urgency.

### What is collective dominance?

Prior to the *Airtours* decision, it was widely understood that tacit collusion was the fundamental economic principle behind 'collective dominance'. Indeed, a major contribution of the recent CFI judgement on the appeal against the Commission's prohibition in *Gencor/Lonrho* was to pave the way for an assessment of collective dominance based on the feasibility of tacit collusion (also referred to as 'implicit co-ordination').<sup>2</sup> Prior to the *Airtours* case, the Commission appeared to share this view. For example, in discussing the Court judgement, the June *EU Competition Policy Newsletter* explicitly states:

*'...the question to assess in cases concerned with collective dominance is the likelihood of tacit co-ordination in the market.'*<sup>3</sup>

Moreover, the 'checklist' which is typically used by the Commission to assess collective dominance in merger cases is based on the standard 'textbook' characteristics which are thought to facilitate tacit collusion in a market. It therefore *only makes sense* if tacit co-ordination is ultimately being investigated.

However, in the *Airtours* case the Commission departed from this underlying economic principle. The decision states that collective dominance is 'not just about tacit collusion'. It is 'sufficient for oligopolists to act – independently – in ways which reduce competition'. Rather than clarifying what collective dominance means, the *Airtours* decision muddies the water. To explain the

source of confusion, we need to return to the economic foundations which underpin merger analysis.

### What economics tells us

In assessing the likely impact of a merger, economics distinguishes between **non-cooperative** and **cooperative** effects. The latter is in effect tacit collusion. The former relates to the possibility that the merging parties will be able to raise price even without the cooperation of rival firms. This corresponds broadly to the legal concept of single-firm dominance. It may well be that the best response of rival firms would be to also increase their prices following the merger, but this would still be a non-cooperative or 'unilateral' effect because it does not depend on cooperation with the remaining firms.

In economics, if a merger is not expected to lead to significant non-cooperative price rises (which is generally deemed unlikely for market shares below those associated with single-firm dominance), and if tacit collusion is not feasible, there are no appreciable grounds for a prohibition.

In the *Airtours* decision, no economic case was put forward that unilateral effects would have been significant (which is not surprising given the merged firm's post-merger market share of 32%) and the case for higher post-merger prices through tacit collusion was very weak. Arguments against post-merger tacit collusion include the following points. First, the requirements of the standard 'checklist' for collective dominance are not satisfied in the UK FPH market. Second, there is no effective punishment mechanism, which in economics is a key requirement for tacit collusion to operate.

### The checklist

The checklist routinely applied by the Commission in joint dominance cases seeks to evaluate the market in question against certain characteristics which are deemed to facilitate tacit co-ordination. Yet in the *Airtours* case there were several ways in which the requirements of the checklist were not met, as the following examples show.

- **Product homogeneity**

Holidays vary by type, location, departure time and quality. With such highly differentiated products and a multitude of prices, co-ordinating on price alone would not be feasible. This was not contested by the Commission. Co-ordinating on capacity is generally viewed as more difficult than on price because of the time lags involved and would have been rendered even harder in the FPH market by the variety of holiday types on offer.

- **Stable and symmetric market shares**

Stable shares help a collusive arrangement, because output is most easily 'allocated' on the basis of current market shares. However market shares in the UK FPH

<sup>1</sup> Lexecon, along with Professor Damien Neven of the University of Lausanne and Professor Ken Binmore of University College, London, acted as economic advisors to Airtours.

<sup>2</sup> The Lexecon *Competition Memo* of June 1999 discusses the CFI's decision and the concept of tacit collusion in more detail. Note that 'joint dominance', 'oligopolistic dominance' and 'collective dominance' can be used interchangeably.

<sup>3</sup> See *Comment on the Judgement of the CFI*, page 23 of the *Competition Policy Newsletter*, June 1999, by Peder Christensen and Philip Owen.

market are relatively volatile. Airtours and Thomas Cook have both grown markedly in recent years, and large firms have left the market. The Commission's view was that market shares are less volatile if the effects of historic acquisitions are stripped out, but this is not relevant for assessing the scope for future co-ordination.

- **Stable demand**

FPH capacity is set 18 months in advance, and firms' capacity levels are not transparent. Demand, in contrast, is highly dependent on disposable income which can be difficult to predict well ahead of time. Demand can also be volatile within the FPH market, particularly as a result of external shocks (such as terrorist activity). These factors make co-ordination problematic.

- **High barriers to entry**

Barriers to entry in the FPH market are low, as the MMC recognised in its recent report on the UK FPH market. Arguably, barriers to expansion are also low: retail space, aircraft and hotels are all available to firms seeking to expand. Moreover, empirical evidence showed that smaller firms were able to offer substitute products to those of the larger firms at competitive prices and were able to purchase inputs at comparable rates.

These and other factors were part of a wider economic analysis which suggested that the conditions usually deemed necessary for collective dominance to be sustainable are not present in the UK FPH market.<sup>4</sup>

## Punishment

Economic analysis shows that the ability to 'punish' firms who deviate from an implicit agreement is an *essential* requirement for tacit co-ordination to be sustainable. Short-lived but bloody price wars (not to be confused with end-of season sales of a 'perishable' good like a package holiday) are the standard mechanism through which deviating firms are brought back into line in a tacitly collusive market.

Indeed the whole underlying logic of the 'checklist' applied by the Commission is to capture the incentive to deviate from potential future co-ordination, and the scope for punishing such deviations through harsh competition in the market.

In the UK FPH market capacity is set 18 months in advance and can only be modestly increased in the short run. This means that there is no credible punishment mechanism to sustain co-ordination. Fixed capacity means that the firm implementing punishment will be unable to serve additional customers if it cuts prices. This has two implications. First, the firm being 'punished' will hardly be punished at all as it will not lose many customers. Second, punishment will be particularly costly for the firms implementing it. If there were no capacity constraints the punishing firm would at least obtain a larger number of customers, and the increase in output will partly compensate the fall in price. If it cannot serve the additional customers, it gets only the fall in price.

<sup>4</sup> It is also worth mentioning that the Commission adopted a narrow 'short haul' package holiday market definition. This was highly contentious (it assumes, for example, that Florida holidays are not in the same market as Mediterranean holidays). Market definition is an important issue in assessing collective dominance as it determines the number of firms supposedly participating in the tacitly collusive outcome.

The only means of punishment would be to increase capacity by a large margin *for the next season*. But this would not be an effective form of punishment for two reasons. First, the prospect of a delayed punishment will be a less effective deterrent when set against the short-term benefits of deviation. Second, with a long time lag, an increase in capacity by competitors is less likely to be clearly understood as punishment in response to a particular past action.

## The Commission's view

The Commission's argument was essentially that, post-merger, the major FPH operators would have an incentive to 'keep capacity tight' and increase price. The argument is summarised in paragraph 66 of the decision as follows:

*'[...] any decision by a tour operator to try to increase market share by increasing capacity (i.e. by offering more holidays for sale) will lead to a fall in prices unless competitors reduce their share by an equivalent amount by cutting supply.'*

This statement amounts to no more than the observation that an increase in supply will lead to lower prices. All this is telling us is that the demand curve for FPHs is downward sloping (i.e. people want to buy more holidays if prices fall). It tells us nothing about the relative competitiveness of this market.

The Commission's argument is merely a statement that firms in the FPH market would have an *incentive* to keep capacity 'tight' in order to sustain high prices. But this incentive exists in all markets: every firm would like to raise prices in order to increase profits. The question is whether firms would be *able* to achieve this. If the Commission does not show that the merging firms would be likely to significantly hold back capacity (unilaterally), nor that the conditions for tacit collusion are appreciably improved, it has no case on grounds either of single-firm or collective dominance – and the merger should not be blocked.

## Conclusion

Collective dominance is an important instrument in merger control. However, it can be used effectively and fairly only if there is a clear understanding of the concept. Prior to the *Airtours* case it was understood that it related to an assessment of the ability of firms to tacitly co-ordinate.

The *Airtours* assessment was a 'forced fit' in terms of collective dominance, as market conditions in FPH were not conducive to the establishment of tacit coordination. To get around this the Commission has shifted the goalposts as to what constitutes collective dominance. This has damaged the credibility of the concept. The Commission should avoid the temptation to use an ill-defined approach to collective dominance simply to block mergers it does not like. Clarification is required: the Commission needs to issue a Notice on the subject so that companies can obtain clear guidance as to how the law will be applied.

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