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Internal Market Affairs Directorate
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Request for information on Frequent Flyer Programmes (FFPs) – Case No. 63645

Reference is made to the EFTA Surveillance Authority's letter of 28 January 2009 and the Surveillance Authority's e-mail of 24 February extending the deadline for submitting comments until 13 March 2009.

Regulation No 684 of 20 June 2007 addresses the restrictive effects on competition of frequent flyer programmes (FFPs) on the market for domestic air services in Norway. The Regulation prohibits all air carriers, foreign and Norwegian, from offering bonus points on Norwegian domestic routes. The Regulation does not prohibit the use in Norway of accumulated bonus points.

The Surveillance Authority raises the question whether Regulation No 684 could be considered to constitute a restriction on the freedom to provide services, as laid down in Article 36 of the EEA Agreement and Council Regulation (EEC) No 2408/92. The Surveillance Authority requests factual information on the Regulation and on any new entry on Norwegian domestic routes since its entry into force. The Authority furthermore requests the Norwegian Government's views on whether the Regulation constitutes a restriction within the meaning of Article 36 EEA, and if so, whether such a restriction is justified and proportionate.

The Surveillance Authority does not explicitly state what effects of the Regulation might constitute a breach of Article 36 of the EEA Agreement. We understand, however, that this may relate to the costs for foreign air carriers of adapting their FFPs to the

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Norwegian regulatory framework. We furthermore understand that the actual costs of such adaptation have not been estimated by ESA.

FFPs constitute an efficient means to induce customer loyalty or fidelity. The structure of FFPs creates lock-in effects of customers and may result in market foreclosure. FFPs can limit competition by reducing the number of airlines active in the market and impede entry by potential competitors by making entry more unprofitable. The anti-competitive effects of FFPs may be particularly strong in markets characterized by one or a few established firm(s) and a potential entrant. The anti-competitive effects of FFPs are further explained below.¹

The Norwegian Government has found that, given the structure of the Norwegian domestic market, offering bonus points on Norwegian domestic routes would reduce competition both between existing airlines and by creating barriers to entry for potential competitors. Reduced competition would lead to higher prices.

The objective of the Regulation is to ensure efficient competition on the Norwegian air services market by, *inter alia*, lowering the barriers to entry which FFPs on domestic routes would create. The pro-competitive effects of the Regulation will not apply to Norwegian domestic routes only. The domestic airlines SAS Norge (SAS), with an important hub-and-spoke network both domestically and abroad, and, to a lesser degree Norwegian Air Shuttle (NAS), would gain a considerable competitive advantage with regard to non-domestic routes if they were to offer bonus points on domestic routes.

The Norwegian domestic market is dominated by the domestic carriers SAS and NAS. As further explained below, allowing the accumulation of bonus points on Norwegian domestic routes would in particular favour the established, Norwegian airlines. It is neither the intention of the Norwegian Government nor the effect of the Regulation to protect Norwegian airlines from foreign competition.

On the contrary, in ensuring efficient competition on the Norwegian market by facilitating entry for new carriers, the Regulation in effect also addresses the objective of ensuring freedom to provide services in the air transport market, as laid down in Article 36 of the EEA Agreement and Regulation (EEC) No. 2408/92. A formal right to provide services would have little practical effect if the competitive regime in the market in question effectively hinders new entry.

The Norwegian Government does not consider the Regulation to constitute a restriction contrary to Article 36 EEA. Should the Surveillance Authority come to a different

¹ The Surveillance Authority refers in its letter to the document “Guide to the European Community legislation in the field of air transport”, to be found on DG Transport and Energy’s home page: http://ec.europa.eu/transport/air_portal/international/doc/brochures/2007_eu_aviation_acquis_handbook_en.pdf. As far as we are aware of, the European Commission has not adopted a formal position on FFPs. It is noted that the contents and views expressed in the above document have not been adopted or approved by the Commission or DG Transport and Energy.

conclusion, Norway would underline that the measure is justified and proportionate. Any additional costs of adapting to the Regulation should be weighed against the additional costs on both airlines and society as a whole of reduced competition.

We are in the process of gathering information on new entries on both domestic and non-domestic routes, and will submit the information requested to the Surveillance Authority as soon as possible. In the assessment of the effects of the Regulation, the situation following both the entry into force of the Norwegian Competition Authority's decision to prohibit SAS from offering FFPs on Norwegian domestic routes on 1 August 2002² and the entry into force of the Regulation on 1 August 2007 will be relevant. The most important entry, NAS, took place shortly after the adoption of the prohibition decision against SAS in 2002. At this stage, we are informed that, apart from NAS, there have been only a few entries on domestic routes without public service obligations since 2002. It should be noted, however, that competition is not only the *actual* competition in the market, but also the *potential* competition following from the threat of new entry.

Frequent Flyer Programmes

Most FFPs have the following characteristics:

- Membership is free and open to any traveller. They however specifically target business travellers
- Members accumulate bonus points when making certain types of trips or purchases with the airline, its alliance partners or other business associates. Bonus points may also be bought separately, in order to achieve a higher threshold.
- When a certain amount of bonus points is accumulated, i.e. certain thresholds are achieved, they can be exchanged for free services such as air tickets, hotel accommodation, service upgrades and, for members having accumulated large amounts of points, various forms of preferential customer treatments.
- FFPs have a non-linear (progressive) structure, conferring upon the customer an incentive to concentrate purchases to one or a few providers. To obtain free flights or preferential customer treatment, the customer needs to surpass certain thresholds in terms of travel purchases within a certain time period. The closer the customer gets to a threshold, the stronger the incentives will be to purchase another flight from that particular airline or alliance.
- Membership is individual and personal. Bonus points are awarded to and may only be used by, the traveller, members of his or her family or travel companion. In the case of business travels, the traveller tends to differ from the purchaser. This may give rise to a pronounced principal-agent problem, by which the traveller (agent) is faced with a different set of incentives from those of the employer (principal)

² The Norwegian Competition Authority's decision V2002-22 of 18 March 2002. The decision entered into force on 1 August 2002. http://www.konkurransetilsynet.no/ImageVault/Images/id_1743/ImageVaultHandler.aspx

- Although in principle taxable in many countries, the private use of frequent flyer points earned by an employee is in practice rarely taxed, for lack of information on the part of the tax authorities. This tax loop-hole is likely to aggravate the principal - agent problem
- FFPs become more attractive the more extensive a network can be offered for bonus points redemption. Alliance airlines therefore merge their FFPs for mutually enhanced competitiveness
- FFPs have, since the early 1980s, developed into separate business entities, and the air carriers generate income through partnerships and the sale of bonus points
- The FFP customer database is an asset in the air carriers' client contacts, and represents an important tool in relation to product development and marketing.

Effects on competition

Frequent flyer programmes may raise serious competition concerns, and have been subject to in-depth scrutiny by European competition authorities. Reference is made *inter alia* to the Nordic competition authorities' 2005 report "Competitive Airlines.

Towards a more vigorous competition policy in relation to the air travel market"³ and the subsequent European Competition Authorities' report "Loyalty programmes in civil aviation".⁴ Both reports explain the potential welfare decreasing and anti-competitive effects of FFPs. The effects of FFPs should be assessed in their legal and economic context. The specific characteristics of the Norwegian market for domestic air services indicate that the anti-competitive effects of FFPs may be particularly strong in this market.

FFPs are, in effect, retro-active, conditional rebate systems⁵. Bonus points are accumulated for each trip. The use of accumulated bonus points is, however, linked to a number of different thresholds, and members cannot make use of the points they have earned until they have accumulated a pre-determined sum. As a customer for each trip will be faced with the possibility of achieving a new threshold with the FFP airline, purchasing a trip with a competing airline will incur additional costs ("switching costs") for the customer. A competing airline will therefore normally not be able to attract the "locked-in" customers by offering a marginally lower price. The switching costs furthermore means that the customer to a lesser degree expects to find better offers and, all other things being equal, has less incentives to look for alternatives. In addition, the complex structure of FFPs makes it more difficult for customers to compare alternative offers, thus making the market for air services less transparent. FFPs therefore also increase customers' search costs. When the customers have fewer

³http://www.konkurransetilsynet.no/iKnowBase/Content/395671/NORDIC_REPORT_COMPETITIVE_AIRLINES_01_02.PDF.

⁴http://www.bundeskartellamt.de/wDeutsch/download/pdf/ECA/Loyalty_Paper_final_ECJ.pdf.

⁵ For a discussion on retro-active conditional rebate, see, *inter alia*, DG Competition's Communication "Guidance on the Commission's enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings"

http://ec.europa.eu/competition/antitrust/art82/guidance_en.pdf.

incentives to search for cheaper alternatives, the airline may set a higher price than would otherwise have been the case.

FFPs are thus an efficient means to ensure customer loyalty. The rebate structure induces the customers to purchase a larger quantity from the airline than they would otherwise have done. As explained by the European Commission with regard to retroactive conditional rebates in general, the loyalty enhancing effect will depend upon the rebate level and the size of the thresholds. The higher the rebate as a percentage of the total price and the higher the threshold, the greater the inducement below the threshold and, therefore, the stronger the likely foreclosure effect (“suction effect”).⁶ The loyalty enhancing effect is probably most important in the business segment, where the traveller tends to differ from the purchaser.

FFPs favour airlines offering extended networks, and smaller airlines face a distinct competitive disadvantage. Customers will accumulate bonus points on more travels with an airline with a large network than with an airline with a smaller network. Furthermore, a free travel holds higher value for a customer if he or she can choose from a large number of destinations. FFPs may therefore strengthen any dominant position and reinforce the possible anti-competitive effects of large hub-and-spoke carriers.

FFPs furthermore favour incumbent airlines. If the incumbent airline(s) offer(s) FFP, the price sensitivity of its customers will be reduced, and it will not be sufficient for a new entrant to offer a marginally better product for the customer to switch to the new entrant. As a consequence, new entrants may be faced with unrealistic efficiency demands in order to attract members of an established airline's FFP.

The anti-competitive effects of FFPs are not limited to dominant airlines only. If a non-dominant airline introduces an FFP, it will also attract more loyal customers. When two airlines each have FFPs, both will have fewer incentives to try and attract customers away from the other. As a result, the airlines will have fewer incentives to compete on price.

The Norwegian domestic market

The Norwegian domestic market is markedly different from the European markets/international flights. The restrictive effects of FFPs on competition and the effects of a prohibition on FFPs on domestic routes should be assessed in this context.

SAS holds a very strong position on domestic routes. There is every reason to believe that the 2002 prohibition decision contributed to the entry and growth of NAS, which is the only significant competitor to SAS. The competitive situation between SAS and NAS may be appreciably limited by FFPs. The market for international flights is very

⁶ See Commission Communication on Article 82 paragraph 37.

different, with a larger number of competitors and less dominant airlines. It must be assumed that in these markets, FFPs will create less loyalty enhancing effects and barriers to entry than in a market with a very dominant airline. It must furthermore be assumed that there will be more room for niche production in international flights, as for example low-cost routes to specific destinations aimed at specific customers.

The Norwegian domestic market is characterized by scattered settlement, low population density and lack of alternative modes of transport. For most of the large domestic routes, trains, buses and cars are not realistic alternatives. Thus, a large number of travellers, and in particular in the business segment, travel by air. As the number of air travels per capita is larger in Norway than in most other countries, FFPs are relatively more attractive and their lock-in effect stronger. The anti-competitive effects will therefore be more important in the Norwegian domestic market. There is reason to believe that it will be more difficult for instance for low-cost airlines to enter the Norwegian market.

Regulation 684 of 20 June 2007

From 1994, the Norwegian air services market was dominated by the two domestic airlines SAS and Braathens SAFE, with approximately 50% each of the market. Both airlines offered FFPs. During that period, it was observed that the two airlines did not compete hard on price in the business segment.

In December 2001, SAS merged with Braathens SAFE. On 18 March 2002, the Norwegian Competition Authority adopted a decision prohibiting SAS from offering FFP on domestic routes.⁷. The prohibition, which expired in August 2007, constituted an important factor in the market entry of a new airline, NAS. NAS concentrates its activities on the larger domestic routes as well as increasingly on non-domestic routes.

At the expiry of the prohibition decision in 2007, the competitive situation was thus considerably changed and the Norwegian market again dominated by two domestic airlines. SAS informed that it intended to reopen its FFP on the domestic routes. NAS had not yet adopted a decision to offer FFP; it could not, however, be ruled out that it would do so. Based on the experience from the Braathens SAFE/SAS duopoly and the 2002 prohibition decision, it was considered necessary to continue the prohibition with regard to SAS, as the still dominant airline. It was furthermore considered necessary to extend the prohibition to all airlines, both established and potential entrants. Allowing NAS to offer FFP would most likely lead to reduced competition in the market, as NAS would probably not compete as hard as to risk becoming the dominant airline and thus be prohibited from offering FFP. Furthermore, it would create unequal conditions of competition between SAS and NAS. The Norwegian Government has furthermore considered the competition effects of allowing airlines with smaller market shares (15%) on both individual routes and on the domestic market in total, to offer FFPs. However,

⁷ The Norwegian Competition Authority's decision V2002-22. The decision entered into force on 1 August 2002: http://www.konkurransetilsynet.no/ImageVault/Images/id_1743/ImageVaultHandler.aspx

as pointed out by a large number of third parties in the consultation procedure, this would lead to unequal conditions of competition between the larger and smaller airlines.

Section 11 of the Norwegian Competition Act of 5 March 2004, in line with Articles 82 EC and 54 EEA, applies to dominant undertakings only. Thus, FFPs will be prohibited pursuant to Section 11 only to the extent they are (i) undertaken by a dominant airline and (ii) constitute an abuse of the dominant position. As explained above, also non-dominant airlines' FFPs may restrict competition. A general prohibition on FFPs rather than individual decisions addressed to individual airlines would safeguard competition by making price the main competition parameter.

The Norwegian Government has considered less restrictive alternatives to a Regulation. In its decisions on airline alliances⁸, the European Commission has found an obligation on the alliance partners to allow competing airlines access to their FFPs on reasonable and non-discriminatory conditions sufficient to ensure competition. This solution would, however not satisfactorily address the competitive concerns on the Norwegian market. It is in particular noted that allowing competing airlines access to each others' FFPs would involve substantial exchange of information between airlines, which would be unfortunate and which may increase the risk and facilitate the implementation of illegal, anti-competitive cooperation. Furthermore, participation in FFPs would be of less interest to low-cost airlines than to airlines traditionally offering FFPs. For low-cost airlines, participation in FFPs would involve additional costs and depart from their low-cost business concept.

Based on the above, the Norwegian Government has found a general prohibition on all airlines from offering bonus points on Norwegian domestic routes the most appropriate means to lower barriers to entry and ensure efficient competition on domestic routes. The Regulation will also have the effect of lowering barriers to entry on routes out of Norway. The Regulation applies equally to domestic and non-domestic airlines and to point-to-point airlines and airlines with large hub-and-spoke networks. The Regulation therefore does not favour specific airlines. It should also be taken into account that by allowing FFP on the Norwegian market, actual or potential competitors without FFP may find it necessary to introduce such programmes, at considerable costs for the airlines.

Freedom to provide services

Adapting their FFPs to the Norwegian regulatory regime may involve certain administrative costs for both actual and potential competitors on domestic routes. Such costs must, however, be assumed to be relatively limited and not constitute an impediment to the freedom to provide air services on the Norwegian market.

⁸ See, *inter alia*, case C264/5 SAS/Lufthansa/United Airlines.

Should the Surveillance Authority still find that such costs constitute an infringement of Article 36 EEA and Regulation (EC) No 2408/92, the Norwegian Government would underline that the Regulation is justified and proportionate. We would point out that the Regulation pursues the objective of the EEA Agreement to ensure efficient competition and a well function market for air transport in the EEA. The Regulation is furthermore necessary and suitable to meet this purpose. As explained above, alternative means have been found less suitable to achieve efficient competition. Based on the characteristics of the Norwegian market, the restrictive effects on competition by FFPs and the limited scope of the prohibition provisions of the Norwegian Competition Act and the EEA Agreement, a general prohibition on FFPs on the Norwegian market is the most appropriate means to achieve efficient competition. It follows from the above that the Regulation does not go further than what is necessary to achieve its objective.

It is noted that any additional administrative costs on the airlines to adapt to the Norwegian Regulatory regime must be weighed against the costs for both airlines and society as a whole of reduced competition in the market. For airlines, regard should in particular be had to the costs of entering a domestic route and capturing an economically viable market share in competition with established airlines offering FFPs. For society, reduced competition will lead to higher prices and less consumer welfare.

Yours sincerely,

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