HOW THE PANDEMIC IS CHANGING THE OUTLOOK FOR AIRLINE MERGERS

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EXEC SUMMARY

Air travel was one of the most affected sectors by the Covid-19 pandemic with traffic slowing to stall speed and now partially and gradually recovering. But interestingly, airline merger activity has continued. Indeed, as Covid-19 restrictions ease and traffic recovers, consolidation among European airlines may well increase. Whether proposed mergers win regulatory approval, given how the pandemic has overturned the economics of aviation, is a different matter altogether.

This article looks at how Covid-19 has muddied the waters of EU competition policy for the airline sector, increasing the challenges that prospective merging parties may face.

Air traffic has been gradually picking up over the course of 2021, but it remains at a fraction of 2019 levels and it is highly uncertain if or when it will get back to pre-pandemic levels. Business travellers have learned to make do with video calls, while testing and quarantine requirements have dulled the appetite of leisure passengers. Despite the industry's diminished prospects – or because of them – interest in mergers shows no sign of flagging. A deal announced in January for International Airlines Group, the owner of British Airways and Iberia, to buy Spain's Air Europa is currently facing an in depth investigation by the European Commission (EC), while in April Air Canada abandoned its planned takeover of Transat after the deal faced regulatory resistance. On top of the financial pressure induced by the pandemic, airlines also face rising costs from carbon pricing and other environmental measures as governments get serious about tackling climate change. In these circumstances, it will be no surprise if underperforming airlines trigger further consolidation in the European market.

And as always, the EC continues to evolve in its standard approach to evaluating airline mergers to take account of these new factors. Some of these considerations have spilled over to other areas of competition beyond mergers, such as the recent state aid decisions for EU airlines during the pandemic, including the focus on 'airport dominance'[1].

The main issues that the regulators are grappling with include the following:

[1] Conversely, state aid decisions have also had an impact on merger activity. For example, the EC had prohibited Lufthansa from further merger activity as part of its state aid decision of 2020, until at least 75 percent of the aid had been repaid.

1 POST-COVID COUNTERFACTUAL

Competition authorities usually weigh up the expected outcome of a merger against the market conditions that prevailed before the proposed deal assuming it to be the most likely counterfactual. But the massive drop in air traffic due to Covid-19 puts a question mark next to the assumption of a return to the pre-pandemic status quo. The regulators' choice of counterfactual will depend on whether they expect traffic to get back to normal and how quick the bounce back may be. This choice, in turn, is likely to affect the assessment of the merger in various ways, including the extent of the overlaps between the parties and the intensity of competition between them and from rivals. The regulators will probably be inclined towards a more conservative counterfactual than the merging parties, resulting in potentially diverging assessments of the impact of the merger on competition.

2 FAILING FIRM DEFENCE

Although possible in principle, it is very difficult to persuade the EC to approve a merger on the grounds that the firm to be taken over is failing – even if the case is strong. To be sure, there is a well-known precedent in the airline sector: the EC accepted such an argument in the Aegean/Olympic tie-up of 2013 at the second time of asking[2].

More recently, however, when considering a proposed merger between Connect Airways and Flybe, the EC suggested that holding valuable take-off and landing slots would automatically preclude a failing firm defence. Unlike aircraft, slots are one of the few airline assets that cannot be moved to other markets. Therefore, the so-called third limb of the failing firm defence, whereby the firm in question is required to exit the market with all its assets, automatically fails. (Incidentally, this was not an issue with the Aegean/Olympic merger as Athens airport did not face capacity constraints at the time, so slots at that airport were not particularly valuable.)

It should be noted, however, that the EC's assessment has not been put to the test. There are some circumstances in which the Commission's position may be challenged, for example if slots make up only a small percentage of an airline's total assets or if the capacity caps they represent are no longer a constraint on competition because demand is expected to remain depressed (and therefore the situation is more similar to the one in the Aegean/Olympics case).

3 'DUAL' MARKET DEFINITION

The EC has historically defined aviation markets by point-to-point routes, also known as origin and destination (O&D). That is, the market is defined as travel services between city or airport pairs. The EC seems to continue following this approach, as shown in its recent assessments of the proposed mergers of Air Canada/Transat (abandoned) and IAG/Air Europa (ongoing). In previous years, starting with the airberlin cases in 2017[3], the EC had considered in addition whether airlines may hold a dominant position at individual airports, irrespective of the routes they are serving from there. As well as affecting how the EC assesses mergers, this 'airport dominance' approach was a key consideration in the Lufthansa state aid

[2] The EC had rejected a previous attempt in 2011 but later considered that market conditions had changed in the interim.

[3] The EC assessed in parallel two separate acquisitions of assets of failing airline airberlin by easyJet and Lufthansa.

case of 2020. In evaluating completion risk, merging parties will clearly need to keep factoring in both sets of potential competition concerns.

4 WHICH DATA IS APPROPRIATE FOR EVALUATING MERGERS?

When assessing airline tie-ups in the past, competition authorities relied on the merging parties for data on frequencies, passengers and revenues. This was typically gleaned from the MIDT database (based on bookings by travel agents), complemented by the parties' own figures. Recently, however, starting with the Delta/Air France KLM joint venture, the EC has stopped accepting this data on the grounds that it does not capture direct sales from airlines to customers, which is often the preferred sales channel for low-cost airlines. This highlights that a challenge not to be overlooked for merging parties and their advisers is agreeing with the EC on appropriate data sources early on. Looking ahead, merger cases are likely to rely on sources that incorporate direct sales statistics in some form, such as IATA databases (PaXIS, DDS) or alternatives including OAG.

5 REMEDIES AND SLOTS

In most of the airline merger cases where the EC has required remedies to preserve competition, it has demanded slot divestments at capacity-constrained airports. With these remedies, merging parties have to make slots available to interested rivals for a period of time. The argument goes that doing so removes the only barrier preventing prospective competitors from breaking into the market. The threat of entry, in turn, should be enough to prevent the merging parties from increasing prices or reducing service quality post-transaction. However, it is not clear whether these remedies will be deemed sufficient while the effects of the pandemic linger. Since traffic remains depressed, the likelihood of would-be challengers entering or expanding remains uncertain. More generally, the EC may be less likely to accept the argument by merging airlines that they face a threat from potential rivals until air traffic returns near to normal and the chances of new competitors entering the market become more realistic. Instead, the EC may turn to upfront buyer or fix-it-first remedies that would provide further certainty that entry will take place.

6 BREXIT

As a result of Brexit, mergers that involve airlines active in the UK are likely to be reviewed by the EC and the CMA in parallel, as it is the case with the proposed IAG/Air Europa merger. There is very limited precedent that gives indication of what would be the CMA's current approach to assess airline mergers. It is not impossible to imagine a world where the CMA could diverge from the EC on issues such as market definition and remedies, among others. The ongoing IAG/Air Europa may shed some light on how the CMA's current thinking, including how they apply the updated merger guidelines to airline transactions.

CONCLUSION

The pandemic will have lasting repercussions for the aviation sector and it is not unlikely that it will be followed by a wave of airline consolidation in Europe in its wake. The EC will need to make sure its template for vetting mergers is adapted to the much-changed environment. This includes taking uncertainty into account but at the same time providing some clarity on key considerations such as defining the relevant counterfactual, so that merging parties can properly self-assess before proceeding with a transaction.

For their part, airlines should not assume it will become easier to win approval to acquire underperforming rivals. Uncertainty around recovery from the Covid-19 traffic slump adds to an already long list of issues that merging parties need to take into account in their risk assessments, including a competitive assessment on route overlaps as well as potential airport dominance concerns.

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