



### III-3.10: The French Directorate General for Competition, Consumer Affairs, and Repression of Fraud organizes a Competition Workshop on the theme “Transportation and Competition”

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#### MAIN INFORMATION

The *Direction générale de la concurrence, de la consommation, et de la répression des fraudes* (DGCCRF - The French Directorate General for Competition, Consumer Affairs, and Repression of Fraud) organized a Competition Workshop on the theme “Transportation and Competition” that took place at the Ministry of Economics, Finance, and Industry, in Paris, on December 16, 2010. These workshops, which are half-day conferences on a given theme, have been organized by the DGCCRF multiple times a year on various themes since 1994. This event was chaired by Anne Wachsmann, a lawyer at Linklaters, and Christophe Lemaire, a teaching assistant at the Law School of the Sorbonne, and a lawyer at Ashurst.

#### CONTEXT AND SUMMARY

The workshop opened with a brief presentation of the DGCCRF’s recent activity by **Nathalie Homobono, the general director of competition, consumer affairs, and repression of fraud at the DGCCRF**. Mrs. Homobono noted that the DGCCRF was currently working on an affair concerning a vertical price fixing cartel in the perfume distribution sector, involving 13 manufacturers and 3 distributors. The sanction of 46 million Euros imposed on the cartelists by the French Competition Authority in 2006, following an investigation by the DGCCRF, was stricken down on appeal by the Court of Appeal of Paris, but confirmed by the Court of Cassation in a 23 November 2010 decision (n° 09-72.031), in which the Court stated that the Court of Appeal had failed to demonstrate “why the short hearings before the Competition Council (former name of the Competition Authority) had caused each company...a personal, effective, and irremediable breach in its right to defend itself.” The affair will be sent back for rehearing by different magistrates of the Court of Appeal of Paris. Indeed, the companies had alleged that the proceedings were too brief to enable them to defend themselves, and they had not known that the DGCCRF was performing an inquiry in 2005, which prevented them from organizing their defense.

Mrs. Homobono also spoke of the Competition Authority’s recent opinions (10-A-25 & 10-A-26) published on December 7, 2010, concerning franchising, commercial lease, and category management practices in the food distribution sector. Indeed, the Competition Authority feared that the habitual practices in this sector involved barriers to entry and exit that distorted competition.

Then, **Anne Wachsmann**, lawyer at Linklaters in Paris, presented the subject at hand by explaining that from the 1970's, the European Commission had established derogations from general competition law for the Transportation sector, but that the legal exemptions for this sector are beginning to disappear, and the general procedural rules established by European Regulation 1/2003 are being fully applied to this sector. Nonetheless, particularities remain in this sector, as exemplified by the European Commission's recent sanction of a cartel in air freight (November 9, 2010), where the sanctions were reduced for "State Action Defense", where the companies were able to demonstrate that government action and overall regulatory framework were conducive to or promoted the formation of a cartel. This is one of the rare examples where the Commission has accepted such a defense. Furthermore, another specificity of the transportation market as a whole is that generally speaking, air transportation is characterized by competition "on" a market (the market being defined as a pair of origin and destination points), whereas the ground transportation market is characterized by competition "for" a market, where carriers compete for exclusivity on a given route.

However, the sector is marked by two larger movements of convergence. The first such movement is the movement of convergence between various modes of transport, towards a model of multimodality. The second such movement is the convergence with the issues formerly encountered in the deregulation of network industries such as telecommunications. This leads to the creation of specialized regulatory agencies such as the *Autorité de régulation des activités ferroviaires* (ARAF — Railway Activities Regulatory Authority) in France, which has to deal with the same issues of property of the network, access to essential facilities, and the relationship between historical operator and new entrants.

**Hubert de Broca**, of the Antitrust and Transport Unit of the European Commission's Competition Directorate-General, presented the theme of Competition in Air Transport. He reminded the audience that this is a highly regulated sector (in the sense of the French word *règlementation*) that gave way to a highly fragmented sector. Each State had its own national flag-carrier, some of which are not viable in a competitive market. Therefore, we observe a movement of mergers and concentrations in this market, such as the fusion between Air France (which had previously absorbed UTA and Air Inter) and KLM; Lufthansa's absorption of Swiss, BMI, Austrian, and Brussels Airlines; and the rapprochement between BA, Iberia, Vueling, and Clickair. This movement of consolidation on the 'traditional' airline market is stimulated by the arrival of a new business model, that of the 'low-cost' airline.

However, the air sector is a cyclical sector, very sensitive to external shocks (September 11, SARS, Icelandic volcano). Although the sector is in overall growth, this fragility and the fact that 60 major European airports will reach capacity saturation by 2025, with only 1/4 of them able to build a new runway by that time, mean that the sector is headed towards further concentration.

The regulatory context is simple, since competition law now fully applies to the sector. However, the principle of historic sovereignty over the air sector remains: the Chicago Convention of 1944 has led to "Air Service Agreements" (ASA) being signed between a large number of states. These ASA are treaties that sometimes go so far as to stipulate the names of the airlines that may fly between the two countries, the airports they may fly from and to, their passenger capacity, and the prices they may charge. Therefore, the European Commission has signed Open

Skies agreements between the European Union, the United States, and Canada, which replace and abolish the former ASA. This allows, for example, Open Skies, a branch of British Airways, to provide service between Paris and New York. The only restriction that persists is that a European airline cannot take a majority share in an American airline.

However, certain ASA remain very restrictive, such as those that various European companies have signed with Russia (ex-Soviet Union). There remain over 1.600 such ASA in force. The European Commission has issued an injunction to concerned member states to renegotiate ASA that fail to meet the open-skies criteria set forth by the European Court of Justice, and which do not respect the principle of equality between all European Union carriers.

The last issue for the air transport sector in the European Union is that of consolidation. The European Commission is favorable to consolidation as long as consumers benefit from it.

In order to determine this, the European Commission has to consider a number of key questions. The first such question is that of the pertinent market: normally, the market is defined as all flights between a given origin and destination. Should the network be taken into account? To what extent are various airports substitutable (Heathrow, Luton, Gatwick, Stanstead; Orly, Roissy, Beauvais)? Are some markets non-route specific, such as Martinique or the Seychelles, where the majority of customers are leisure customers and are simply looking for a sunny destination in the winter months at the lowest cost, perhaps making the question of route redundant? Is there substitutability between various modes of transportation on certain routes, especially for the train? Lastly, is there a difference when examining competition on a given route between nonstop and flights with stopovers?

After addressing these questions, the Commission performs a line-by-line competition analysis. This analysis takes into account potential horizontal effects between current competitors and effects on third parties. Notably, in the Iberia-BA merger, the Commission demanded commitments from BA on a certain number of routes, of which the London-Chicago route, on which Virgin Airlines depended on bookings made by BA for a large portion of its customers. BA had to commit to maintain the system in place in order not to harm Virgin Airlines. Also, the Commission is sensitive to the problem of airport saturation, and looks to ensure that new entrants can secure landing slots.

One of the novelties of the BA/Iberia decision was that the Commission accepted for the first time that BA could sell landing slots to competitors when there was more than one competitor bidding for the slot. Otherwise, when only one competitor is interested in acquiring a landing slot, the transfer must be performed free-of-charge.

The Commission has a zero-tolerance policy for cartels in the airline industry, as seen in the 2001 SAS/Maersk decision and the 2010 decision on airfreight.

In the future, the Commission will be attentive to continue the liberalization process, to support consolidation as long as consumers benefit, and to sanction cartels.

Next, **Christophe Lemaire**, professor at the Law School of the Sorbonne and a

Lawyer at Ashurst, Paris, introduced the theme of Competition in the Rail Transport Sector.

He explained that the railway sector is defined by a certain number of specificities. The first is that there are very complicated technical constraints (rail gauge, electric current, traffic management and signaling). The second is that the sector is highly dependent upon coordination with other modes of transportation. The third is that the security standards are very high. The fourth is that there are extremely high barriers to entry for competitors. The fifth is that the State is highly involved in the sector, through subsidies, environmental policies that promote rail as an environmentally friendly mode of transport, and railway organizational policies. Lastly, railway transport is a sector in decline, with declining numbers of passengers and volumes of freight transported, and a lack of technical innovation.

The railway sector is one of the last opened to competition, even though it was specifically mentioned in the Treaty of Rome, in the only article that makes mention of a 'public service'. Rail freight was liberalized between 2003-2007, and passenger transport from January 1, 2010. But the next step remains to be defined. The European Commission proposed a recast directive, regrouping all existing legislation, on September 17, 2010 that should clarify the way forward. On the national level, the Grignon Report will be published by the French Parliament to define how France plans to cope with passenger transport liberalization on the local level.

In the meantime, on the national level, there is a functional division between the *Société nationale des chemins de fer* (SNCF), the national railway company, and *Réseaux ferrés de France* (RFF). SNCF operates and owns trains, while RFF maintains and owns the physical railway network. Under this arrangement, train stations remain the property of RFF, who delegates their management to the SNCF. Furthermore, the SNCF controls traffic on RFF's network, under a particular arrangement: the Prime Minister of France nominates the Director of Traffic within the SNCF.

This is indicative of the mix of soft and hard law that reigns in the railway sector: although France has decided on strict legal and accounting separation between the SNCF and RFF, the overlap in activities remains strong, with a strong dose of state intervention. Meanwhile, the European Commission has not explicitly stated that such separation is required by European legislation, and as such, has not occurred in other states, such as Germany.

Lastly, cabotage is controlled by the ARAF, the French railway activities regulator. The ARAF also approves the tolls set by RFF for railway use. This is another French specificity: on one hand, the tolls are so high that they account for about 30% of the price of a TGV ticket; on the other hand, the European Commission has stated that the toll system is not in conformity with European legislation because there is no incentive for operators to reduce costs or improve punctuality and service. The ARAF also has the power to grant operating licenses, resolve disputes, and impose sanctions.

So, in conclusion, the speaker states that the French market is facing two obstacles. The first is the upheld monopoly of the SNCF for national passenger transportation. The second is that the State has not made it obligatory for Regions to launch an invitation to tender for local rail service. On the other hand, the State has not forbidden Regions to proceed thusly, putting the SNCF in competition with

a competitor for local rail service.

We can therefore see that in Europe as a whole, the first general tendency for railway operators is to adapt the traditional model of cooperative, whereby former cooperatives between various national railway monopoly operators become operators in their own right, such as Eurostar. The second tendency is the diversification of activities abroad, a domain in which the Deutsche Bahn is especially strong. The last tendency is that operators are diversifying horizontally by providing complementary services to rail transportation, such as the SNCF's sister companies, Keolis and Effia.

Following this presentation on the railway market in France and in Europe, **Henri Piffaut**, deputy head of the transport and state aid unit of the European Commission's Competition Directorate-General, presented the European Commission's supervision of State Aids in the transportation sector.

The European Commission's goals are to maintain access to markets, avoid advantages to historical operators, and avoid the persistence of inefficient market players. In order to do this, the Commission applies the "Altmark Criteria", from an eponymous case decided by the European Court of Justice on July 24, 2003, when analyzing the subsidies provided by states to infrastructures and operators bearing public service obligations, whether in order to indemnify them for these obligations, or to save them from bankruptcy. These criteria are that: firstly, the public service obligations must be clearly defined; secondly, the method of compensation for such obligations must be clearly established *ex ante*; thirdly, the compensation must be "fair" and not superior to the costs actually engendered by the activity; fourthly, the operator must fulfill its public service obligations at the best price, which is presumed to be the case when the State has launched an invitation to tender, or which can be verified *ex post* by benchmarking. These criteria are further defined by European Regulation 1370/2007, which defines "fair" compensation as the difference between the costs and the revenue generated by the activity, plus a reasonable profit. Mr. Parfait rhetorically asked the audience how could reasonable or habitual be defined in a sector where nothing is 'reasonable' or 'habitual', for the market is entirely dominated by monopolies and state intervention, which shows that these notions are still imprecise and ill-defined by European legislation.

As concerns the air transport sector, investments in infrastructure must often be performed by the State, because they are too expensive and unprofitable for one company to take on itself. The Commission issued guidelines for analyzing such investments in airports and seaports in 2005. This especially concerns regional airports, which could not survive without heavy public subsidies. The European Commission therefore takes the position that such airports (or at least the runway) are public goods, rather than corporate assets, which removes them from the scope of state aid law. But, if the terminal is considered a corporate asset, it falls under European supervision for state aid.

In any case, there is an *ab initio* presumption that such investments are state aid, but such analysis is extremely complicated when the airport operator is unprofitable: without the state aid, the operator would have to shut down operations; at the same time, the operator has no incentive to reduce his fixed costs when it is dependent on subsidies, which means that its upstream prices are not market prices. Should we therefore consider that the suppliers are also

receiving state aid?

Mr. Piffaut mentioned a number of decisions that exemplify this problem, most of which concern regional airports (46% of cases examined by the Commission). Such decisions include those relative to Charleroi airport, Kassel Calden airport, and the Aéroports de Paris decision. In such analyses, the Commission always takes into account the general interest objectives pursued by the State's investment.

As concerns state aid to corporate restructuring, we observe that there is a tendency towards concentration on all transport-related markets. However, there remain problematic sectors, such as freight transportation in Greece, and air transportation in countries such as Hungary, where national operator Malev is dependent on state aid to continue operations. This is a particularly difficult problem, because States are often reluctant to abandon their flag carriers for obvious political reasons.

Next, **David Sevy**, an economist and director of LECG consulting group, gave an economist's perspective on these issues.

Mr. Sevy noted that the market is extremely heterogeneous, both from the point of view of supply and of demand. On the demand side, the client base is segmented between business and leisure travelers, whereas on the supply side, there are problems of rarity (slot and schedule allocation), and high fixed costs for investment with high economies of scale and product range effects, that all distort competition.

Competition is also unequally strong according to the mode of transportation. New entrants are discouraged by the weak profitability of all sectors of the transportation market, and by the pricing policies that make only some clients profitable. These clients must be 'skimmed off' by a new entrant, which creates problems for the historical operator, who earns fewer profits but must continue to fulfill the same public service obligations. The good news for competition is the arrival of the low-cost model, that has reduced prices for consumers, but the heavy reliance of these carriers on highly subsidized regional airports creates doubt as to the true overall economic benefits of this model. Finally, the sector is characterized by high volatility in the level of competition, because of frequent entries and departures from the market.

Road transportation is characterized by competition *for* a market, whereas air competition is characterized by competition *on* a market. Rail transport varies by country: in the United Kingdom, the rail network was broken down into segments, and there was an invitation to tender for each segment. But, overall, there is an international movement towards consolidation, as demands are more and more sophisticated, and former monopolies are using their know-how to satisfy such demands in other countries.

Whether the pursuit of rail liberalization in Europe will follow the model of telecommunications liberalization or the model of energy liberalization remains to be seen. Telecommunications experienced exponential technological advances, which promoted competition. This was not the case for the energy sector, and will probably not be the case for the railway sector, which means that perhaps the energy liberalization model is more appropriate for this sector.

As concerns air transportation, consolidations and alliances have led to an improvement in supply and services, with more flights and better connections. This has taken airlines out of an uncertain situation, but we must be attentive to make sure that this does not lead to permanent advantages with royalties and dominant positions.

It is not clear that alliances and consolidations lead to higher prices for consumers: in the Oneworld alliance between Iberia and British Airways, only 7 routes were found to be affected, with a 5% increase in business class tickets prices, and a 2% increase in economy class. A similar study in the United States concluded that there were no negative effects for consumers, as long as there were at least two carriers competing on the same route. This can be explained both by the phenomenon of competitive discipline, as well as extremely high price transparency due to the Internet. We can therefore conclude that the increases in efficiency are very high for very limited drawbacks.

Another phenomenon that is beginning to be documented and studied is the phenomenon of intermodal competition. For an analysis of the effects of this phenomenon by the European Commission, see its merger review decision on the Véo/Transdev merger.

But, a parallel phenomenon is that of intermodal cooperation. This leads to a convergence between schedules and points of service, as well as integrated ticketing. An example of this is joint ticketing for Air France flights and TGV trains run by the SNCF directly to Charles de Gaulle Airport.

The final speaker at this event was **Pierre Cunéo**, director of the Line C of the RER at the SNCF (former director of rail strategy and regulation at the SNCF), who gave the perspective of an operator on the liberalization of railway transportation in France and in the European Union.

Mr. Cuneo began by telling the audience that less than 50% of the SNCF's business is actually railway-related, and that these activities are hardly profitable at all. The SNCF observes that the liberalization of rail transportation is a teleological goal of the European Commission. The SNCF is subject to competition by airlines and by private cars. It also has intermodal transportation arrangements with road freight, cabotage, and ticketing.

How can the SNCF cope with liberalization? An economic model has to be found that is viable for customers and operators. Obviously, the SNCF will lose market share, since it currently has 100% market share, but the 'cake' will have to be increased from its current size, so that it can be shared between multiple operators.

The issue at hand for regulation is larger than the simple issue of liberalization or competition. For example, on December 14, 2010, the French government signed a contract with the SNCF for the continuation of its 'Corail' service of highly unprofitable long-distance classic trains, whereby the State will provide 210 million Euros of compensation to the SNCF for continuing this service. Otherwise, the SNCF would have been obliged to cease these operations. The SNCF is also subject to a high number of constraints, especially as concerns security. Running trains is therefore very expensive and requires large amounts of public subsidies.

Access to essential facilities such as the network, merchandise warehouses, and maintenance workshops must also be defined by the regulator (see French Competition Authority's decision n°09-SOA-01), but the regulator must simultaneously ensure that the historical operator does not receive any undue advantages, but also, that it not bear an undue burden.

Finally, all operators must have long-term visibility on tolls, both as concerns their level and their structure.

The regulator must also be prepared to resolve disputes concerning slot allocation, where multiple operators wish to run trains on the same tracks at the same time.

European legislation on railway liberalization also needs to be clarified, since it has given way to divergent interpretations by different member states. Whereas in France, RFF and the SNCF are strictly separated, the former managing the infrastructure and the latter providing transportation services, in Germany, the Deutsche Bahn (DB) simply created a subsidiary to manage infrastructure, creating accounting separation but not legal separation of corporations and property. This gives the DB a competitive advantage over the SNCF on both the national and international markets. Therefore, the SNCF strongly requests that the European Commission provide legal security, visibility, and clarity on the applicable legislative framework.

On a national level, the tariffs for the SNCF's passenger services are still set at the ministerial level, and ticket prices have increased at a slower rate than the SNCF's overhead charges. This means that the high-speed TGV service, which used to provide most of the SNCF's profits, is no longer as profitable as it was before. This question must be addressed politically, especially in the context of liberalization and the European Regulation on Public Service Obligations in public transportation (Regulation n° 1370/2007).

The last question to be addressed in the context of liberalization is what will happen when a line is won over by a competitor: what will become of the employees on the line and the rolling stock? Will the competitor be obliged to take over employment of the SNCF's employees, and if so, will they be subject to the same restrictive and onerous labor arrangements? If not, the historical legacy of high payroll charges and restrictive labor rules that the SNCF has to account for will be an enormous, and unfair, competitive disadvantage for the former monopoly.

Therefore, concluded Mr. Cuneo, Regulation and Competition Law must work together to provide clarity and rules in order to allow operators to behave in an enlightened fashion.

**Links with other documents in the same sector**

## **BRIEF COMMENTARY**

This conference was a timely contribution to the ongoing process of liberalization of transportation markets in the European Union. Each speaker brought a unique and very rich perspective to the table, and all contributions went in the direction of a common theme: now that European legislation has decreed full applicability of competition rules to the transport sector, what next?

All participants, directly or indirectly answered this question: appropriate regulatory schemes spearheaded by an independent, specialized regulatory authority need to be put into place for this sector in order to provide the *ex ante* regulatory framework necessary for competition to be effective and beneficial in this sector.