COMMISSION DECISION

of 6 July 1992

on the compliance of certain air fares with the requirements of Article 3 (1) of Council Regulation (EEC) No 2342/90

(92/398/EEC)

THE COMMISSION OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Economic Community,

Having regard to Council Regulation (EEC) No 2342/90 of 24 July 1990 on fares for scheduled air services [1] and in particular Article 5 (3) thereof,

Whereas the Government of the United Kingdom requested the Commission by letter dated 15 April 1991, registered by the Commission on 2 May 1991, to examine, pursuant to Article 5 (1) of Regulation (EEC) No 2342/90, a number of fare increases filed by Community air carriers for certain routes to and from the United Kingdom;

Whereas the United Kingdom withdrew that request in relations to some inbound fares by letters dated 16 May 1991 and 16 July 1991;

Whereas a detailed examination of the information on costs and revenues as provided by the air carriers concerned following various requests of the Commission has led to certain conclusions based upon the criteria explained in Annex III,

HAS ADOPTED THIS DECISION:

Article 1

The air fares listed in Appendix 1 to this Decision comply with Article 3 (1) of Regulation (EEC) No 2342/90.

Article 2

The air fares listed in Appendix 2 to this Decision do not comply with Article 3 (1) of Regulation (EEC) No 2342/90. These fares cannot, therefore, serve as reference fares for subsequent seasons. Member States concerned have not fulfilled their obligations under Article 3 (1) of the Regulation. They are requested to take appropriate measures in order to comply with these obligations and to inform the Commission accordingly.

Article 3

This Decision is addressed to the competent authorities of Belgium, Denmark, Germany, Greece, Spain, France, Italy, Luxembourg, Portugal, the United Kingdom and to the Community air carriers Sabena, SAS, Lufthansa, Olympic Airways, Iberia, Air France, Alitalia, Luxair, TAP Air Portugal and British Airways.

Done at Brussels, 6 July 1992.

For the Commission

Karel VAN MIERT

Member of the Commission

[1] OJ No L 217, 11. 8. 1990, p. 1.

ANNEX I

Fares for which the Commission's examination pursuant to Article 5 of Regulation (EEC) No 2342/90 has led to the conclusion that they are in compliance with the criteria laid down in Article 3 (1)

Route	Airline	Tarif			
		Outbound		Inbound	
LHR-CPH	BA	£	216		—
MAN-CPH	BA	£	205		—
LHR-BRU	BA	£	145	BFR	9 490
MAN-BRU	BA	£	173		—
LHR-FCO	BA	£	250		—
LHR-LIN	BA	£	199		—
MAN-LIN	BA	£	254		—
LHR-PSA	BA	£	221		—
LHR-TRN	BA	£	201	LIT	560 000
LHR-VCE	BA	£	229		—
LHR-BLQ	BA	£	228	LIT	543 000
LHR-LUX	BA	£	166	LFR	10 420
LHR-ATH	BA	£	328		—
LHR-MAD	BA	£	229		—
LHR-BCN	BA	£	215		—
LHR-AGP	BA	£	253	ESP	62 500
LON-LIS	BA	£	231		—
LGW-FAO	BA	£	249		—
MAN-CDG	BA	£	204		—
LHR-NCE	BA	£	192		—
LHR-NCE	BA	£	202		—
LHR-BOD	BA	£	205		—
LHR-FRA	BA	£	175		—
LHR-DUS	BA	£	140		—
LHR-HAM	BA	£	189		—
LHR-CGN	BA	£	140		—
LHR-HAJ	BA	£	189		—
LHR-STR	BA	£	192		—
LHR-BRE	BA	£	170		—
MAN-DUS	BA	£	192		—
MAN-FRA	BA	£	204		—
LHR-MUC	BA	£	208		—
LHR-TXL	BA	£	200		—
CPH-LHR	SK	DKK	2 880	£	216
CPH-MAN	SK	DKK	2 945	£	205
BRU-LHR	SN	BFR	9 490	£	145
BRU-MAN	SN	BFR	12 180	£	173
FCO-LHR	AZ		—	£	250
LIN-LHR	AZ		—	£	199
LIN-MAN	AZ	LIT	688 000	£	254
PSA-LHR	AZ		—	£	221
TRN-LHR	AZ	LIT	560 000	£	201
VCE-LHR	AZ		—	£	229
BLQ-LHR	AZ	LIT	543 000	£	228
ATH-LHR	OA	GRD	113 600	£	328
ATH-LHR	OA	GRD	107 100		—
MAD-LHR	IB		—	£	229
BCN-LHR	IB		—	£	215
AGP-LHR	IB	ESP	62 500	£	253
LIS-LON	TP		—	£	231
FAO-LGW	TP		—	£	249

Route	Airline	Tarif	
		Outbound	Inbound
CDG-BHX	AF	—	£ 185
CDG-MAN	AF	—	£ 204
NCE-LHR	AF	—	£ 202
NCE-LHR	AF	—	£ 192
BOD-LHR	AF	—	£ 205
FRA-LHR	LH	—	£ 175
DUS-LHR	LH	—	£ 140
HAM-LHR	LH	—	£ 189
CGN-LHR	LH	—	£ 140
HAJ-LHR	LH	—	£ 189
STR-LHR	LH	—	£ 192
BRE-LHR	LH	—	£ 170
MUC-LHR	LH	—	£ 208
FRA-BHX	LH	—	£ 209
DUS-MAN	LH	—	£ 192
FRA-MAN	LH	—	£ 204
DUS-BHX	LH	—	£ 172
TXL-LHR	LH	—	£ 200

ANNEX II

Fares for which the Commission's examination pursuant to Article 5 of Regultion (EEC) No 2342/90 has led to the conclusion that they are not in compliance with the criteria laid down in Article 3 (1)

Route	Airline	Tarif			
		Outbound		Inbound	
LHR-CPH	BA	—		DKK	2 880
MAN-CPH	BA	—		DKK	2 945
MAN-BRU	BA	—		BFR	12 180
LHR-FCO	BA	—		LIT	723 000
LHR-LIN	BA	—		LIT	575 000
MAN-LIN	BA	—		LIT	688 000
LHR-PSA	BA	—		LIT	643 000
LHR-VCE	BA	—		LIT	652 000
LHR-ATH	BA	—		GRD	107 100
LHR-ATH	BA	—		GRD	113 600
LHR-MAD	BA	—		ESP	56 450
LHR-BCN	BA	—		ESP	45 150
BHX-CDG	BA	£	185	—	
BHX-DUS	BA	£	172	—	
BHX-FRA	BA	£	209	—	
FCO-LHR	AZ	LIT	723 000	—	
LIN-LHR	AZ	LIT	575 000	—	
PSA-LHR	AZ	LIT	643 000	—	
VCE-LHR	AZ	LIT	652 000	—	
LUX-LHR	LG	LFR	10 420	£	166
MAD-LHR	IB	ESP	56 450	—	
MAD-BCN	IB	ESP	45 150	—	

ANNEX III

Compliance of air fares with the requirements of Article 3 (1) of Regulation (EEC) No 2342/90

1. *Introduction*

By note date 15 April 1991 (received by the Commission on 2 May 1991) the competent authorities of the United Kingdom have formally requested the Commission to examine whether a number of air fares comply with Article 3 (1) of the above Regulation. The air fares have comply with Article 3 (1) of the above Regulation. The air fares have been filed by British Airways on behalf of itself and Sabena, TAP, Air France, SAS, Lufthansa, Iberia, Alitalia, Olympic, Airways and Luxair for the summer season 1991.

In addition the Commission was asked to examine if the Member States concerned had carried out their responsibility under Article 3 (3) of the Reguation.

By notes of 16 May and 16 July 1991 the United Kingdom authorities have withdrawn their request for some inbound fares which, therefore, have not been examined by the Commission.

2. *Obligations of the Commission, Member States and air carriers*

2.1. General

Regulation (EEC) No 2342/90 has established a system of double disapproval for air fares which exceed a reference fare (1) by more than 5 %. In this area a proposed fare can only be prevented from entering into force if both Member States concerned disapprove. However, a safeguard has been built into the Regulation which allows a state to submit the matter to the Commission for a decision since Member States are obliged not to approve a fare (Article 3 (3)) that is, in relation to the criteria defined in Article 3 (1), excessively high to the disadvantage of users or unjustifiably high in view of users or unjustifiably low in view of the competitive market situation.

Article 3 (1) established that air fares must be reasonably related to the long-term fully allocated relevant costs of the applicant air carrier.

2.2. Commission

According to Article 5 whenever the Commission receives such a request it must first inform the other Member States and the air carriers concerned and give them the possibility to submit any comment which they might wish to make. This was done by letter of 6 May 1991.

Furthermore, the Commission must decide within 14 days of receipt whether the air fares shall remain in force during the examination. The Commission in view of the situation during the Gulf crisis, decided to allow the air fares to remain in force during the examination period (2).

Finally, the Commission has to decide whether the air fares in question are reasonably related to the long-term fully allocated relevant costs of the applicant air carrier.

2.3. Member States and air carriers

In addition to their obligations pursuant to Article 3 (1) and 3 (3) of the Regulation (EEC) No 2342/90 Member States are pursuant to Article 9 obliged to make available to the Commission all necessary information required for carrying out a thorough scrutiny of the situation. The same obligation applies for air carriers.

3. *The criteria of Article 3 (1)*

3.1. General

It is necessary to look at the air fares against the long-term fully allocated relevant costs and to examine what these concepts mean.

Long-term will clearly mean that short-term fluctuations in costs cannot be taken into account. Therefore, changes in costs and revenues have to be taken into account only if the available information suggests that they go beyond usual short-term variations.

Fully allocated relevant costs would mean that all costs which relate to an air fare must be allocated fully and not only to the route in question. Any marginal approach, although commercially reasonable, would not be acceptable. On the other hand it would also mean that costs which relate to other air fares shall not be considered.

(1) See definition given in Appendix to Annex II of Regulation (EEC) No 2342/90.
(2) Decision of 16. 5. 1991.

3.2. Route costs

In the first instance this would mean that all directly attributable costs to the routes in question must be taken into account. Such costs would include fuel, airport charges, flight crew etc. Current accounting practices already follow this approach.

The allocation of indirect costs per route is more complex. Inevitably it is necessary to specify a number of assumptions in order to allocate such costs to routes and thereafter. It is possible to allocate costs to specific routes fairly accurately.

Several accounting methods exist and an air carrier may for one reason or another prefer one specific system. It is not the Commission's task to set out which method is the correct one, indeed this would not be possible. An air carrier, however, must use the method chosen in a consistent and controllable way and it must make sure that all indirect costs are allocated. The Commission can then proceed on the basis of the breakdown of costs used by the individual air carrier.

3.3. Fare-type costs

From this point on its is necessary to make a number of assumptions in order to calculate the costs related to a specific fare-type.

On international flights different fare-types can be divided into fully flexible fares (first class, business and economy) and promotional fares (Eurobudget, PEX, APEX). They differ in respect to service to passengers (seat pitch, meals etc.) varifying passenger services and, in particular, with regard to the conditions attached.

On intra-European flights the lowest fully flexible fare, i.e. the lowest fare without any restrictions on use is considered to be, in terms of Regulation (EEC) No 2342/90, the reference fare. The request presented by the United Kingdom, aims at examining this fare-type. In the case of British Airways the so-called club-fare must be considered as the lowest fully flexible fare.

The costs of producing a seat do not differ greatly between the various classes. The premium classes offer more room per seat and better cabin services. These cost differences can be estimated by introducing some simple assumptions.

The real difference with regard to the cost level of different fare-types, however, results from the conditions attached to the air fare or lack of same. The normal fully flexible economy fare (or club) carries no penalty if the passenger decides not to use his reservation. The opposite is true for promotional fares. This means that air carriers calculate with load factors which are considerably higher for promotional fares than for fully flexible fares. Statistics bear this out and while promotional fares have only a small percentage of 'no shows' a much higher percentage can be expected for fully flexible fares. In fact load factors of 55-60 % are normally realised for fully flexible fares while about 85 % are realized for promotional fares. Such figures naturally assume that the air carrier is able to operate the right equipment and has an efficient yield management system.

In conclusion it can be stated that costs can be allocated with a good degree of accuracy to a route but that certain assumptions then have to be made, in particular about a reasonable load factor, in order to calculate the costs in relation to specific fare-types.

It should be noted that aire fares can, in addition to the criteria of the Regulation (EEC) No 2342/90, always be examined on the basis on the relevant competition rules.

4. *Relationship between an air fare and costs*

The final measure for any comany must clearly be the overall profit at company level. Although in past years most air carriers only realized profits before tax of about 2 % it is generally recognized that a profit margin between 10 and 15 % would be reasonable i.e. an operating ratio (OR) of 110-115 to cover financial charges and to provide a return to equity . At present very few air carriers are able to achieve the latter (1).

This ratio cannot, however, be applied directly on a route to route basis. It must be accepted that a normal air carrier's network will include some good routes and some bad i.e. a certain degree of cross-subsidization between routes is justifiable.

(1) An operating ratio indicates the relationship between revenues and costs.

On a route basis therefore a further 10 % margin would not be excessive which would bring the acceptable operating ratio to about 125. In addition to this it is necessary to reckon a margin for errors in allocating costs of about 10 % which would mean that a resonably justifiable oeprating ratio for an air fare would approach 140. This corresponds to the threshold used for the earlier case before the Commission (Sterling Airways case) (1).

In order to calculate the operating ratio for the air fare it is necessary to make an assumption of a reasonable load factor (2). In the Commission's assessment a load factor of 55 % has been used. This is in most instances significantly lower than that which the air carriers have been able to achieve but it is normally acknowledge that this is a reasonable albeit cautious value in order to carry out such an assessment.

The elements considered when calculating fare-type ORs are attached.

The overall profitability of a route may, under certain circumstances, be important for assessing trhe compatibility of our air fares on the route in question.

A port route performance, i.e. the route is running at a loss or just covering costs, may indicate that certain assumptions of the calculation have not been correct. It cannot be excluded that a load factor of 55 % is not achieved on specific, economically difficult routes and that possibilities to downsize the equipment used are, for technical reasons, limited. Similar considerations may be valid for new routes under development. In these cases a poor route performance may outweigh the conclusions based on the calculation of a fare-type related OR.

A poor route performance may, however, be compatible with the conclusion that a specific fare is too high. These cases indicate cross-subsidiation between fare-types in the sense that the low price elasticity for fully flexibles fares (business travels) is used for financing artificially low promotional fares (leisure travel). Such a situation may distort competition between carriers and is, therefore, not acceptable.

Although the poor profitability of a route may lead an air carrier to optimize its income by increasing fares in market segments with a low price elasticity of demand it would be difficult to accept this where little or no competition exists for fully flexible fares and, in particular, in situations where competition exists for promotional fares e.g. where charter traffic is important. In such circumstances the low promotional fares for scheduled airlines may even constitute predatory behaviour.

To take account of the developments over a longer term the Commission generally approved fares with an operating ratio above 140 if the route showed overall negative results for at least two seasons ; fares with very high fare-type OR (more than 180) were, however, disapproved.

5. *Approach in practice*

In view of the fact that information on both routes and air fare profitability is necessary, the Commission's services have written to the air carriers and Member States concerned and asked them to provide such information (3). It has been extremely difficult and time-consuming for the Commission to obtain the necessary information from the different airlines. Due to the turbulences caused by the Gulf crisis some carriers have had problems in providing updated data about their costs ; others have not yet established calculation methods which correspond to the requirements of the Regulation.

For the Commission's approach in practice, the following points should be noted :

— The situation for the preceding season(s) has been examined and the general development of the fare has been observed i.e. whether the operating ratio is diminishing or increasing. The overall profitability of the route has also been noted as well as the competitive situation (i.e. number of air carriers active on the route in question) and the OR for the air fares have been calculated. To exclude the effects of short-term fluctuations, the Commission has taken a flexible viewpoint and, in general, not disapproved fares which are beyond the threshold of an operating ratio (OR) of 140 if the overall results for the route concerned were negative for at least two seasons.

— The examination of costs was carried out solely on the basis of information provided through the individual accounting systems of the air carriers concerned, including the breakdown into cost categories.

(1) Written procedure E/1771/80.
(2) See point 3.3.
(3) According to Article 9 of Regulation (EEC) No 2342/90 airlines and Member States are obliged to provide all necessary information to the Commission.

— Since air fares in many instances differ significantly between inbound and outbound a separate analysis has been carried out for each of these fares.

— For the allocation of all relevant costs some airlines have had difficulties in providing updated datea because their accountancy systems were not up-to-date or because they were unable to provide cost data on a route-by-route basis. So far, the Commission has taken a flexible view and tried to accommodate these difficulties by a number of estimates and assumptions.

— Some airlines told the Commission that the factors attributing a higher percentage of the total cost to business class (+ 6 % for seat-related costs and + 10 % for passenger-related costs) were too low. The Commission is looking into improving the methodology used for its decisions, in cooperation with experts from the airlines and the Member States. For the present proposal, however, the Commission arrived at the conclusion that the built-in margin of error of 15 % should take account of these uncertainties. Nevertheless, the OR threshold of 140 has been applied in a very flexible manner.

— A number of routes showed extremely high OR for business class (up to around 200) and negative overall results for the route. That means that these airlines attempt to have very low fares for the leisure traffic with cross-subsidization from the business traffic. Such a situation may distort competition and is not acceptable for routes where little or no competition exists for fully flexible fares and, in particular, in situations where competition exists for promotional fares e.g. where charter traffic is important. Therefore, fares with any very high fare-type OR (above 180) have been disapproved, according to the information furnished by the airlines, even if the overall route performance was negative over two seasons.

— In the case of interlining an air carrier will not receive the full fare but only a prorated part. However, this is taken into account when calculating the operating ratio for the route.

— It must be assumed that in most situations where access to a route is limited because of capacity problems then competition would normally be severely restricted. Of the routes in question this is the case in particular for those using Heathrow and Gatwick. However, even if the fare had been disapproved according to the criteria mentioned above, it would have been accepted if there was sufficient competition on the route (in general at least three carriers with at least 20 % market share each provided that all these carriers could act as price leaders). There was in fact one route where this criterion was applied. For three other routes, the fares were not approved because the OR was too high and the third carrier, even though with a market share above 20 %, was servicing the route on fifth freedom rights within price leadership.

— It should be recalled that the examination concerns the fully flexible fares which for some time have been considered as too high in Europe. In this context it becomes difficult to be convinced about competition on a route when the air carrier in question refers back to the agreement reached at IATA as justification for the air fare. — Other companies told the Commission that they were just matching their fares with those of their competitors according to Article 3 (5) of Regulation (EEC) No 2342/90. However, Article 5 (1) would lose its sense if the Commission accept such a matching-up to a higher fare level as justification for the cost-relatedness referred to in Article 3 (1).

— The fares examined were put in force for the summer season 1991 which was heavily influenced by the negative effects of the Gulf crisis. In fact, the route OR calculated on the basis on the real 1991 data (in so far as provided for by airlines) showed in most cases a remarkable drop compared to previous seasons. However, according to the method mentioned above, negative route results can only be considered if they are maintained over a longer period, that is over at least two seasons (Article 3 (1) of Regulation No 2342/90 expressly referring to the long-term fully allocated relevant costs). For the summer season 1991 this approach could, therefore in most cases, not yet take the effect of the Gulf crisis into account.

The Commission is however of the opinion that the Gulf crisis had negative effects over a longer term (that is well into 1992), particularly with regard to the level of laod factors. When deciding in May 1991 not to suspend the tariffs during examination, the Commission already expressly referred to the Gulf crisis. To be consistent with this decision and to take account of the difficult situation the aviation industry had to face in 1991, the Commission again checked all fares which would have been disapproved according to the method so far applied. The operating ratios were recalculated on

the basis of load factors which according to the (limited) information provided by the airlines were severely reduced in summer 1991. Instead of 55 % for the business class the Commission applied to these tariffs a load factor of 45 %, and instead of 80 % for other (promotional) traffic a load factor of 70 %. As a result, the Commission, as an exception, approved a total of 18 fares on routes which were particularly affected by the Gulf crisis and which under normal circumstances would have had an OR clearly above the threshold of 140.

In the light of the foregoing considerations the Commission decided to accept fares not only if the fare-type operating ratio is, according to the abovementioned methodology, below 140, but also :

— when the route is running at a loss or just covering costs, without indication of cross-subsidization between business class and discount fares. This is assumed to be the case if the operating ratio for the route has been below 100 during at least two seasons, unless the fare-type OR was very high (above 180),

— on a route which is operated by more than two carriers and where the market share of the third (fourth, fifth) carrier(s) is above 20 % and on condition that they may act as price leaders. In these cases it is assumed that workable competition on the route in question will by virtue of market fares put pressure on too high fares,

— where the load factors severely reduced in 1991 by the effects of the Gulf crisis, have drawn the fare-type operating ratios below the threshold of 140.