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AIRLINE COMPETITION

-- Note by Japan --

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*More documents related to this discussion can be found at
<http://www.oecd.org/daf/competition/airlinecompetition.htm>.*

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1. Introduction and Historical Backgrounds

1. Japan deregulated its domestic airline market in stages from the enactment of the Civil Aeronautics Act in 1953 to the amendment of this legislation in 2000 into its current form.

2. With respect to market players, Japan Airlines Co., Ltd. (hereinafter “JAL”) was established in the form of a state-owned special corporation as the so-called national flag carrier in 1953. It was followed by the creation of All Nippon Airways Co., Ltd. (hereinafter “ANA”) and Toa Domestic Airlines Co., Ltd., later renamed as Japan Air System Co., Ltd. (hereinafter “JAS”). The number of market entrants had been very limited for a long time under the system where separate licenses were granted for individual routes for the purpose of demand-supply adjustment regulations.

3. For a period of around 15 years from the early 1970s, under the policy known as *the 45/47 regime*¹, JAL was to operate international flights and trunk domestic flights while ANA was to operate trunk and provincial domestic flights and JAS to operate provincial domestic flights. These three carriers served separate components of the domestic aviation market. Meanwhile, it was not permitted for more than one carrier to operate flights on any single route. In 1986, *the 45/47 regime* was discontinued and flight operations by two or three carriers on the same route were permitted. This was called the shift to double or triple tracks. Thus, the deregulation proceeded in stages. In addition, JAL was reorganized into a fully private company in 1987.

4. After the enactment of the Civil Aeronautics Act, no air fare or charge could be set or revised without governmental approval. Under this system, the fare was to be calculated by adding an appropriate profit to the appropriate cost incurred under efficient management. After this full cost principle was replaced in 1988 with the standard cost principle, under which the same fare range applied to the same travel distance, the fare regulations were eased in a phased manner as is the case with the entry regulations.

5. In 1998, the market saw new entrants for the first time in 35 years: Skymark Airlines Inc. (hereinafter “SKY”) and AIRDO Co., Ltd. (hereinafter “ADO”). In 2000, the Civil Aeronautics Act was amended to massively deregulate both the market entry system and the fare system. In 2002, JAS was merged into JAL due to financial difficulties, but JAL itself began to experience financial difficulties and the Enterprise Turnaround Initiative Corporation of Japan (now the Regional Economy Vitalization Corporation of Japan; hereinafter “ETIC”) started to provide it with support for revitalization in 2010. In recent years, the domestic aviation market has been changing rapidly, after the entries of three Japan-based low cost carriers (LCCs) in 2012.

6. The following focuses mainly on the domestic airline market where relatively many actions related to competition legislation and policies have been taken, and aims to present the current overview of the Japanese domestic airline market, the activities of the Japan Fair Trade Commission (hereinafter “JFTC”) for this market, and a related case regarding financial difficulties.

¹ This refers to the domestic aviation operation structure based on the cabinet decision in 1970 (or the 45th year in the Showa Period) and the circular notice from the Minister of Transport in 1972 (or the 47th year in the Showa Period).

2. Structure and Functions of the Airline Sector

2.1 Major domestic air carriers

7. At present, the major air carriers operating in the domestic aviation market comprise the two leading air carriers of JAL and ANA, four latecomer air carriers, SKY, ADO, Skynet Asia Airways Co., Ltd., which launched its service in 2002 (hereinafter “SNA”), and Star Flyer Inc., which was inaugurated in 2006 (hereinafter “SFJ”), and four low-cost carriers of Peach Aviation, Ltd. (hereinafter “Peach”), Vanilla Air Inc. (hereinafter “Vanilla”), Jetstar Japan Co., Ltd (hereinafter “Jetstar”) and Spring Airlines Japan² Co., Ltd.

8. Several latecomer air carriers and LCCs have capital relationships³ with the leading air carriers.

9. For fiscal year 2012, ANA held the largest market share⁴ of 44.6% in the market for regular domestic flights, which served 859.7 million passengers, followed by JAL with a market share of 34.9%, SKY with 7.8%, ADO with 2.3%, SNA with 1.6% and so on. The three LCCs (Peach, Vanilla and Jetstar) hold a total market share of nearly 3% and the top LCC, Peach, has an approximate market share of 1.5%.

10. Domestic air carriers compete with one another in (1) air fares, (2) flight route networks and number of routes served, (3) punctuality, (4) frequency, (5) aircraft and in-flight services and (6) others, such as lounge services and other off-flight services. Especially for fares, individual companies propose early bird fares, discounts for specific routes or flights and other options.

2.2 Allocation of slots at domestic airports

11. In accordance with the Civil Aeronautics Act⁵, air carriers must submit flight schedules to the Minister of Land, Infrastructure, Transport and Tourism (hereinafter “Minister”) to obtain approval prior to operating flights departing from or arriving at any of the four busiest airports in Japan, including the Tokyo-Haneda (Haneda) and Tokyo-Narita (Narita) Airports. There are two requirements for authorization. First, the flight schedules must be appropriate to the safety of aircraft operations. And second, the schedules must ensure proper and rational uses of these busy airports, for example, by providing transport services convenient to users through promoting competition and creating diverse transport networks. The approval granted remains effective for five years in accordance with the Ordinance for Enforcement of the Civil Aeronautics Act⁶. In contrast, for operating flights departing from and arriving at non-busy airports, air carriers need only submit flight schedules.

12. With the practical allocation of slots at the busy airport of Haneda, which was considered to particularly attract the highest demand, non-leading air carriers, specifically the four latecomer air carriers such as SKY, used to be treated preferentially in order to stimulate entries as well as the expansion of scale of the latecomer air carriers, and to spur competition in accordance with the review in the council of advisers in the Ministry of Land, Infrastructure, Transport and Tourism (hereinafter “MLIT”) including the

² Spring Airlines Japan Co., Ltd will begin to operate flights in June 2014.

³ At present, there are capital relationships among these companies. Regarding latecomer air carriers, ANA holds voting rights in ADO (See 3 below), SNA and SFJ, although ANA’s stake in each is below 20%. Among LCCs, ANA is the largest shareholder of Peach, holding a 38.7% stake, and wholly owns Vanilla, whereas JAL is a co-parent company of Jetstar Japan (See 3 below).

⁴ Fiscal 2014 Nikkei Market Share Survey

⁵ Paragraph (1) of Article 107-3 in the Civil Aeronautics Act

⁶ Article 219-2 of the Ordinance for Enforcement of the Civil Aeronautics Act

report in June 2004, titled “*Desirable Use of the Haneda Airport in the Foreseeable Future*”. On the other hand, at the moment of the slot allocation in 2012, given that the latecomer carriers which had already entered into the market constructed solid business foundations, the preferential treatment in slot allocation for these companies dropped and the criteria for slot allocation to them became identical with those to leading carriers. However, it is still considered necessary to give a certain level of consideration to those air carriers under a predetermined level in scale, with a view to continuing the policy of promoting competition among air carriers through the encouragement of market entries.

2.3 *Regulations applying to domestic air carriers*

13. As discussed in 1 above, the current domestic aviation market is subject to regulations based on the Civil Aeronautics Act after the amendment in 2000. These regulations are far more relaxed than before 2000.

14. The regulations on market entries (operation of air transport business) have shifted from a license system based on demand-supply adjustment on individual routes to a system of granting approval for individual businesses with a focus on safety examinations. As mentioned in 2.2 above, for the purpose of operating flights departing from and arriving at non-busy airports, air carriers need only submit their schedules in advance, which means that flight schedules are left to the discretion of air carriers. For the purpose of withdrawal from the aviation market, i.e. discontinuation of air transport operations, air carriers now need only submit notification⁷.

15. Air fare settings and revisions can be made simply by submitting prior notification. All fares and charges are in principle left to the discretion of the air carriers, although the Minister has the authority to issue an order to change unfair fares and charges, such as unjustifiable discriminatory treatment against specific users.

16. To maintain passenger transport services on domestic flight routes that are becoming difficult to service because of a contraction of demand, while service is necessary for the lives of locals, agreements on joint operation between two or more carriers operating flights on these routes are exempt from the application of the Antimonopoly Act on the condition that they are approved by the Minister in consultation with the JFTC pursuant to the Civil Aeronautics Act⁸. However, this exemption does not apply in such events as the use of any unfair trade practices or where a substantial restraint of competition in a particular field of trade unreasonably impairs users’ interests.

17. At present, there is no domestic flight route subject to the exemption of application of the Antimonopoly Act.

3. The JFTC’s Activities in the Aviation Sector

3.1 *Mergers and Acquisitions*

18. The following presents three actual mergers and acquisitions (M&A) cases subject to the JFTC’s review. The first pertains to the business consolidation between JAL and JAS (“relevant parties”) in fiscal year 2001. The second concerns business collaboration between ADO and ANA in fiscal year 2002. And the third concerns the establishment of a joint venture by the Qantas/Jetstar Group and JAL in fiscal year 2012.

⁷ Article 118 of the Civil Aeronautics Act

⁸ Articles 110 and 111-3 of the Civil Aeronautics Act

3.1.1 *Business consolidation between JAL and JAS in fiscal year 2001*

19. **Brief description of the case.** In this case, JAL and JAS planned to carry out business consolidation by setting up a holding company serving as their parent company and later reorganizing themselves into business-specific companies.

20. **Definition of the particular field of trade.** With regard to this case, the JFTC carried out an intensive review of the domestic air passenger transport business, the air passenger transport business operating flights to and from the Haneda Airport, the air passenger transport business operating flights to and from the Itami Airport in Osaka and the specific domestic flight routes where JAL and JAS compete with each other. The Haneda and Itami Airports are among the busy airports where air carriers are required to get the approval of the Minister for operating flights.

21. **JFTC's concern.** The JFTC considered that the merger is likely to substantially restrain competition and conveyed the following concerns to the relevant parties.

- A decrease in the number of leading air carriers from three (JAL, JAS and ANA) to two (JAL/JAS and ANA) would further facilitate fare setting action that got used to be coordinated.
- On routes served by a smaller number of air carriers, the ratio of flights with specific flight discount fares to all flights and their discount ratio were lower. The decrease in the number of air carriers would have significant impacts on the competition.
- The limit of arrival and departure slots at busy airports and other factors makes new entries difficult. Under these circumstances, new entries would not be likely to restrain coordinated action for fare setting.
- As a result, general consumers with no means to negotiate the fares would be significantly inconvenienced by the fares set by air carriers.

22. **Measures suggested by the relevant parties.** In response to these concerns expressed by the JFTC, the relevant parties suggested taking measures as a remedy, which include those described below.

- Measures for encouraging new entries (including return of departure and arrival slots)

They would return to the MLIT a portion of their departure and arrival slots at Haneda Airport for nine flights in October 2002. If the slots for spurring competition (See paragraph 23 below), including those for nine flights mentioned above, is insufficient before the reallocation of departure and arrival slots in February 2005, they would return an additional portion of slots at Haneda Airport for a maximum of three flights to the MLIT.

- Measures concerning fares and others
 - The ordinary fares for all major routes would be uniformly reduced by 10% and would not be raised for at least three years.
 - They would launch or add flights on routes served only by any other single leading air carrier and on routes where any other single leading air carrier had an advantage in the number of flights.

23. **MLIT's principal measures for spurring competition.** In light of the circumstances at that time, the MLIT decided to introduce some slots to promote competition ("slots for promoting competition") for the purpose of increasing passenger convenience by allowing latecomer air carriers to use them to compete with the leading air carriers and commence new business operations. On the occasion of the revision to the allocation of slots in February 2005, the MLIT decided to fundamentally review all existing slots and add new slots for expanding "slots for promoting competition" in order that latecomer air carriers are able to compete on a par with the leading air carriers and to expand their business, and to become competitors functioning as effective restraints against leading air carriers.

24. **Conditions of the latecomer air carriers:**

- Existence of latecomer air carriers engaging in business activities on particular routes

There were two latecomer air carriers engaging in business activities on particular routes with the use of slots at the Haneda Airport for six flights. They were SKY and ADO. Some air carriers considered specific plans for expanding their business activities on the assumption that extra slots at the Haneda Airport for nine flights would be additionally allocated.

- Existence of air carriers and others with new launch plans for the future

Apart from that, there were two latecomer air carriers, including SNA, which planned new launches by February 2005 after receiving part of the slots at Haneda Airport, which have yet to be allocated to latecomer air carriers.

25. **JFTC's judgment:**

1. Return and reallocation of departure and arrival slots

Evaluation until February 2005. The measures of returning part of their slots at the Haneda Airport suggested by the relevant parties and the MLIT's creation of slots for promoting competition resulted in a sufficient number of slots matched with the plan for increasing flights mentioned above paragraph 24 and paved the way for the expansion of the latecomer air carriers. For these reasons, it was thought that the competition would be active even though on limited routes until February 2005.

Evaluation after the fundamental review of the allocation of slots in February 2005. In connection with the allocation of departure and arrival slots starting February 2005, the MLIT decided to make a fundamental review of all existing slots and to further increase slots for promoting competition to enable latecomer air carriers to compete on a par with leading carriers and to expand their businesses. As noted, some air carriers had specific plans to compete on a par with leading carriers and to implement full-scale business expansion on the condition that they would secure the necessary slots. In view of these situations, these latecomer air carriers are deemed likely to become competitors that could effectively compete against leading air carriers in the field of domestic air transport.

2. Measures concerning fares and others

The actions of the companies to lower ordinary fares and to launch and increase flights on routes served only by the other single leading air carrier or on routes where the other single leading air carrier had advantages in the number of flights can be regarded to some extent as taking advantage of the effect of rationalization archived by the merger for the benefit of general consumers.

3. Conclusion

Consequently, in consideration of the measures suggested by the relevant parties, the implementation of the proposed merger plan is considered unlikely to substantially restrain competition in the field of domestic air transport.

Incidentally, the company born by the merger between the relevant parties in this case failed to achieve a financial recovery after the merger and became effectively bankrupt. It was revitalized in 2010 with the help of public assistance. This case is discussed in the section 4.

3.1.2 *Business collaboration between ADO and ANA in fiscal year 2002*

26. **Brief description of the case.** In the case, ADO and ANA planned to collaborate on the route between Haneda and Chitose Airport in Sapporo in order to revitalize ADO, for which civil rehabilitation proceedings were underway pursuant to the Civil Rehabilitation Act, and to increase their management efficiency and passenger convenience.

27. **Brief description of the business collaboration.** According to the explanations given by ADO and ANA, they planned to enter into collaboration including code-sharing while mutually maintaining and respecting their respective independence.

28. The code-sharing they planned is as follows.

- The flight numbers (codes) of both ADO and ANA would be set at six flights operated by ADO.
- ANA would purchase half of the seats of these flights from ADO and resell them as seats of its own flights (through a seat purchase arrangement). The seats purchased by ANA would not be returned to ADO (in a hard block method).
- ADO and ANA would separately set their own fares and the number of seats to which different fare options would apply.
- ADO and ANA would submit a report to the JFTC in the event of changing the terms of the code-share agreement. They would also revise the terms of agreement at the time of termination of the ADO rehabilitation plan and report the results to the JFTC.

29. **Viewpoint under the Antimonopoly Act:**

- Basic Viewpoint

ADO's entry into the market is seen to have produced a significant effect of promoting competition even though the number of routes it serves is limited. From the perspective of competition policy, too, its business rehabilitation is considered important.

On the other hand, depending on its details, the business collaboration between ADO and ANA might cause some problems under the Antimonopoly Act, such as an act of price restriction by the two companies or ANA's unjust restraint of ADO's business activities. Thus, the JFTC reviewed the points specified below.

- Evaluation under the Antimonopoly Act

With regard to the code-sharing in this case, first, the two companies agreed that they would independently set their respective levels of different fares and the numbers of seats to which

different fares would apply. Second, ADO is considered to be maintained as an independent competitive entity in view of the agreement under which the two companies would each have the same number of seats after the sale and purchase of hard block seats. And third, their arrangement stipulates that if the relevant parties revise the code-sharing agreement, they are required to report the revision to the JFTC. In light of these factors, their collaboration is deemed to be unlikely to cause problems under the Antimonopoly Act.

3.1.3 *Establishment of a joint venture by the Qantas/Jetstar Group and JAL in fiscal 2012*

30. **Brief description of the case.** In this case, the Qantas/Jetstar Group based in Australia and JAL planned to establish a new joint venture in order to embark on the LCC business. The Qantas/Jetstar Group was to have a 33% stake, while JAL also has a 33% stake and two other domestic firms together hold a 34% stake in the joint venture. This plan was not intended to put all or part of the existing business activities of the relevant parties under joint management but to establish a joint venture aimed at operating a new LCC business. However, given that the businesses of the relevant parties are related to that of the joint venture, the information on airline services provided independently by the companies concerned, such as wholesale fares, would be shared through operations of the joint venture, which would help a coordinated relationship between the relevant parties to form.

31. **Definition of the particular field of trade.** Given that customers select and use aviation services for the purpose of moving between different cities, the JFTC defined direct flights between different cities as a particular field of trade. It was found that the Qantas/Jetstar Group and JAL competed with each other on seven international flight routes departing from and arriving in Japan, including code-sharing flights.

32. **Evaluation under the Antimonopoly Act.** With regard to domestic flights, the relevant parties are not in a competitive relationship because there is no such flight operated by the Qantas/Jetstar Group. It is virtually impossible for this group and other foreign air carriers to enter the domestic flight market without the cooperation of a Japanese full service airline (FSA) carrier, as long as overseas air carriers are in principle barred from operating domestic flights. The Qantas/Jetstar Group is thought to need cooperation from a Japanese air carrier or equivalent for the purpose of launching domestic flight services. From the viewpoint of customers, their plan will add an option, which is an LCC service offered by the joint venture, to the domestic flight market. The JFTC has therefore judged that the establishment of the joint venture in this case is not likely to substantially restrain competition in any particular field of trade.

33. In the international flight market, flight operation by the joint venture will increase options for customers to choose from. On five routes among the seven on which the relevant parties compete with each other, there is no flight operated by any other air carrier. If any coordinated relationship is formed between the relevant parties as a result of flight operation by the joint venture, it is likely to have a significant impact on the competition. However, the relevant parties have no plan to operate flights by the joint venture on those routes where they compete with each other, including the five routes. The JFTC has therefore judged that the establishment of the joint venture is not likely to substantially restrain competition in any particular field of trade.

3.2 **Unilateral conducts**

34. Among the JFTC's reviews of unilateral conducts, the following discusses a case in connection with air carriers where the JFTC issued a warning on fare setting by JAL, JAS and ANA in fiscal year 2002.

35. **Brief description of the case.** Among the domestic flight routes between Tokyo and Kyushu area including Miyazaki, Kagoshima and Fukuoka Prefectures, the three leading air carriers, namely JAL,

JAS and ANA, were found to have set their discounted air fares for specific flights on the Tokyo-Miyazaki, Tokyo-Kagoshima and Tokyo-Fukuoka routes on which latecomer air carriers operate flights at a level equivalent to or lower than the level of the reduced fares set by the latecomer air carriers. It was also found that the degree of discounts were higher for the discounted air fares for specific flights on routes where they competed with latecomer air carrier and that their fare levels on some routes were lower for the cost incurred.

36. These acts of setting fares might violate the provision of Article 3 of the Antimonopoly Act, which prohibits private monopolization, in consideration of the positions and statuses of the three leading air carriers in the market, their overall business capabilities, the level of fares in question and their impacts on latecomer air carriers.

37. **Response of the JTFC and the three leading air carriers.** The JTFC pointed out the issue to the three leading air carriers, suggesting that their conduct might violate the provision of the Antimonopoly Act, and requested them to take voluntary remedial actions. In response, the relevant leading air carriers decided to increase the discounted air fares for specific flights on the routes concerned and announced the upward fare revision.

4. Financial Difficulties (Support for JAL's Revitalization)

38. The following takes a look at the revitalization support offered to JAL in 2010⁹ as an example of a response to domestic air carriers falling into financial difficulties.

39. JAL began to experience financial difficulties for several reasons, including, first, its business structure inflexibility including excessive ownership of large aircrafts and maintenance of flights on unprofitable routes; second, its organizational structure inflexibility that led to delays in decision making; and third, the financial crisis that erupted in the fall of 2008. In 2010, JAL made a request for revitalization support to the ETIC and filed an application to the court for corporate reorganization proceedings and had its stock delisted.

40. ETIC was a stock company set up as a state-authorized corporation serving the purpose of providing business revitalization support. Nearly half of its capital was held by the Japanese government. Enterprises eligible for ETIC's support scheme¹⁰ were those with excessive debt burdens despite owning useful management resources. ETIC's activities under the support scheme include purchase of the debt from supported company or request to the financial institutions for debt forgiveness, provision of due diligence, financial or personnel support for the supported company, and the development of a business revitalization plan for it.

41. In January 2010, ETIC decided to provide support for JAL and the court commenced the corporate reorganization proceedings. In this case, ETIC financed JAL with 360 billion yen, which included the portion financed by the Development Bank of Japan, and dispatched an outside business manager to the failing air carrier (JAL) as its chairman and representative director. In the corporate reorganization proceedings, debt forgiveness amounting to 521.5 billion yen and a 100 percent capital reduction regarding the existing shares were executed. JAL also enjoyed different kinds of preferential tax treatments. In addition, JAL's business and organizational structures were revised, its business was downsized, its workforce and personnel costs were cut, its corporate pensions for current and retired employees were slashed and some of its subsidiaries were sold off for the purpose of revitalization.

⁹ With regard to this case, Japan delivered a presentation at the February 2014 meeting of Working Party 2 (WP2) of the Competition Committee.

¹⁰ The support scheme at the time of offering support to JAL.

42. As a result of these support actions, JAL's financial results rallied sharply and the company posted its highest-ever income in fiscal 2011. It relisted on the Tokyo Stock Exchange in fiscal year 2012.

43. In connection with this revitalization support, there was a dilemma over competition policy and another dilemma between competition policy and other policies. The dilemma over competition policy means, for example, that while the revitalization support for a specific large company might distort the competition in the market¹¹, lack of revitalization support may lead to the withdrawal of a company functioning as an effective restraint against its competitors from a highly oligopolistic market with severe entry barriers and to the emergence of a market that remains consistently non-competitive. It is necessary to make decisions in consideration of the balance between these two possible scenarios. The dilemma between competition policy and other policies implies that it is necessary to give consideration on, for instance, the maintenance of safe and stable operation of flights as public means of transport from the perspective of ensuring aviation networks, the maintenance of multiple means of transport for the public, the maintenance of employment from the perspective of socioeconomic needs, the prevention of chain-reaction bankruptcies of business partners and the prevention of hindrances to people's lives and the activities of industry.

¹¹ The report (released on May 23, 2013) from the "Subcommittee for Review on Competition Policy Concerning Public Support" under the Council for Transport Policy in the MLIT, which assessed the specific support actions and measures implemented in the process of JAL revitalization, says that it is undeniable that the support for JAL lacked attention to maintaining a sound environment for competition with other market players at the time of implementing support measures as a result of taking into account the special circumstances under which Japan's aviation market is effectively an oligopoly of two companies, while recognizing the need for public support for JAL's revitalization.