

**Summary:**

## **Norwegian Domestic Aviation – Competition and Monopoly**

This report presents the results of an evaluation of the possible outcome of a monopoly situation in domestic aviation in Norway. The evaluation, which has been carried out by the Institute of Transport Economics for the Norwegian Ministry of Transport and Communications, is based on knowledge of the domestic market, economic theory and international experiences.

The domestic market in Norway has changed drastically since 1990 and a number of distinct phases can be identified. Up to 1993, the market was regulated and two airlines, SAS and Braathens, shared the traffic with equal shares. With few exceptions they operated different non-overlapping route networks.

When the market was opened to competition in 1994, both airlines increased capacity by entering routes operated by their competitor. As a result both established more or less similar overlapping nationwide route networks. The capacity at the then Oslo Airport Fornebu was a restraining factor and during 1997-98 both airlines waited for the new Oslo Airport Gardermoen to open.

The new airport, which opened in October 1998, had a much higher capacity and led to increased air traffic. A new airline, Color Air, started routes from Oslo to Bergen, Ålesund and Trondheim. The overall seat capacity increase, however, was far more extensive than that of the new airline, especially due to capacity increases by SAS. The result was excess capacity and highly reduced fares to the benefit of passengers. The airlines lost money and Color Air had to give in already in September 1999.

After 1999 both SAS and Braathens reduced capacity but only very slowly because both were reluctant to give away market shares. Finally, heavy losses led to serious financial problems for Braathens and the airline was taken over by SAS in 2001.

In Europe, the degree of domestic airline competition varies. By 2001 some countries like Great Britain, Italy and Spain experience domestic competition, while in other countries, among them Sweden, France and Germany domestic competition is less pronounced than a few years ago.

According to economic theory, a monopolist will take advantage of his position by reducing capacity and thus achieve higher prices on average. Nominal air fares will not necessarily be increased, but discount fares will be less available. Route schedules will be designed and prices will be set in such ways that aircraft utilization and load factors increase. Further, a monopolist will enjoy network benefits, mainly on the market side.

A contestable market will in principle set limits for monopolistic behaviour. However, most studies indicate that necessary prerequisites in this respect like lack of scale effects and no barriers to entry or exit, are not fulfilled. Therefore, actual and not only potential competition is necessary if reduced fares shall be achieved.

Scenarios are driven by players with differing goals. After deregulation, the roles of the different actors are more distinct. Competition authorities want to encourage active competition. Thus, frequent flyers programmes in the domestic market in Norway were prohibited from 1 August 2002. Further, predatory pricing is in principle forbidden, but is difficult to determine such practise due to the very low short-term marginal costs in the aviation industry.

The Ministry of Transport and Communications is responsible for routes and transport supply in Norway. Services can be bought according to Public Service Obligation rules. Further, the Ministry (together with Ministry of Finance) sets external conditions for the industry and Norwegian Air Traffic and Airport Management (NATAM).

NATAM, that operates state owned airports, will become a state owned limited company in 2003. A greater focus on profit may then lead to a rationalised airport structure.

The extent to which a monopolist will exploit his positions depends on his perception of:

- The probability of a new entrant
- Market reactions (price sensitivity)
- Strength of authorities (short and long term)

Two scenarios were developed in the course of the evaluation, the one describing a short-term exploitation of monopoly position and the other describing a more cautious long term thinking monopolist. Since a monopolist easily can change capacity and prices if traffic fails or a new entrant appears, the short-term exploitation scenario is the more likely one.

The development during the first year with monopoly (2001-2002) supports this argument. Seat capacity is reduced with 15-20 % and yield has increased 15%. However, traffic has stagnated and cabin factors are still rather low. A failing business market due to 11th September and insecurity may be one reason. A mature market in Norway, price sensitivity and less willingness to travel at inconvenient times of the day / week may be other reasons. Capacity reductions have thus not yet had the intended effects on profitability.