COMPETITION TRIBUNAL
REPUBLIC OF SOUTH AFRICA

Case No: 77/LM/Oct02

In the large merger between:

South African Airways (Pty) Ltd

and

Air Chefs (Pty) Ltd

Reasons

Approval

The Competition Tribunal issued a Merger Clearance Certificate on 25 October 2002 approving the merger without conditions. The reasons are set out below.

The merger

The transaction

South African Airways (Pty) Ltd ("SAA") is buying all the remaining shares in Air Chefs (Pty) Ltd. This is a vertical merger where the customer, SAA, is acquiring an upstream service provider, Air Chefs.

The parties to the transaction

Transnet Ltd, a public company of which the South African Government is the sole shareholder, controls SAA.

The primary target firm is Air Chefs (Pty) Ltd., a joint venture established between Transnet Ltd (holding 51% of the issued share capital) and Fedics Strategic Investments (Pty) Ltd (holding the remaining 49%).

An evergreen management agreement vested control of Air Chefs with Fedics.

Rational for the transaction

SAA is concerned that it was paying too much for the catering services supplied by Air Chefs due to the Evergreen Management agreement, which contains a cost-plus 250%

mechanism. It was also not satisfied with the service levels, that Air Chefs supplied.

The Cabinet sub-committee on Restructuring recommended that the most viable restructuring option for SAA would be the acquisition of Air Chefs by SAA.

Evaluating the merger

Relevant market

SAA operates in the airline passenger services market, with a generally limited accompanying freight and cargo service. SAA is the largest domestic airline in the country.

Air Chefs operates in a market upstream from that of SAA, providing in-flight catering services to domestic, regional and international airlines, which entails, inter alia, the provision of meals, loading services, stock storage, chilling facilities and sanitation.

SAA offers flights to, from and within South Africa. Air Chefs operates kitchens in Johannesburg, Cape Town, Durban and George.

According to the parties the various in-flight caterers have kitchens in the following South African cities:

Table 1

Air Chefs	**Gate Gourmet**	**LSG Skychefs**	**Dyasons**	**Ferucci**	**Ground Crew**
Johannesburg	Johannesburg	Johannesburg			Johannesburg
Cape Town	Cape Town	Cape town			Cape Town
Durban		Durban			Durban
George			George		
			Port Elizabeth		
				East London	
					Lanseria

The Commission, in its recommendation to us, indicates that one needs to consider the direct cost of transport, as well as the indirect cost, when deciding the geographic market because of e airlines stipulations such as the hygiene and freshness of the food they serve. They say that airlines would thus be reluctant to source from any geographic location other than the departing airport. Most of the caterers also have kitchens either within the airport or very close to the airports that they service.

Taking into account all the above we agree with the Commission that SAA operates, for the purposes of this analysis, in a domestic, a regional and an international market and that in the case of the market for in-flight catering and related services each airport constitutes a separate geographic market.

Vertical effects on competition

The effect of the merger is to further integrate Air Chefs activities as a supplier into that of its customer, SAA. It is thus only the potential vertical effects of the merger that we need to be concerned about. More specifically we will focus on foreclosure and whether it would be possible for SAA to raise its rivals' costs or raise the barriers to entry, after the merger.

There are currently 6 in-flight caterers, which compete in some or all of the geographic markets namely Air Chefs, Gate Gourmet, LSG Skychefs, Dyasons, Ferucci and Ground Crew. According to the parties Air Chefs caters for 28 different airlines, Gate Gourmet for 15, LSG Skychefs for 12, Daysons for 4, Ferucci for 3 and Grand Crew for 3.

Air Chefs, as indicated in table 1 above, is not present in Port Elizabeth, East London or Lanseria either before or after the merger. Dyasons, Ferucci and Ground Crew[1] service these smaller airports and the merger would, thus, not affect these geographic markets. We will therefore focus on the remaining airports namely Johannesburg, Cape Town Durban and George.

The parties submitted the following market share data with regard to in-flight catering, per geographic market:

Table 2.

	Air Chefs	Gate Gourmet	LSG Skychefs	Dyasons	Ground Crew	HHI
Johannesburg	43%	20%	30%	-	7%	3198

1 Both Dyasons and Ferucci are small players that service niche markets and Gate Gourmet is a new entrant.

Cape Town	32%	16%	37%	-	16%	2905
Durban	56%	-	25%	-	19%	4122
George	60%	-	-	40%	-	5200

As can be seen in table 2 the remaining geographic markets are all highly concentrated.[2] In the larger cities there are 3 to 4 players present at each airport while at smaller centers only 2, depending on the amount of air traffic that the airport carries.[3] Smaller airports just don't have the economies of scale to support more than two in-flight caterers.

According to the parties some airlines use the services of two or more in-flight caterers, Air Chefs plus another, as shown in table 3. One of the reasons for this is that Air Chefs is not present at the smaller airports such as Port Elizabeth Airport, East London Airport and Lanseria Airport, which are serviced by niche players. These players, according to the parties, although presently not located at the larger airports, nevertheless pose a threat of entry to their larger competitors, should they raise prices excessively or render poor service.

Table 3

Air Chefs	**Gate Gourmet**	**LSG Skychefs**	**Dyasons**	**Ferucci**	**Ground Crew**
SAA			SAA	SAA	
		Comair	Comair		
SA Express			SA Express	SA Express	SA Express
Nationwide		Nationwide			
			SA Airlink	SA Airlink	SA Airlink
Air Namibia	Air Namibia				
Air Mauritius	Air Mauritius				

The Commission, however, found the barriers to entry into the in-flight catering market

2 A post-merger HHI above 1800 is generally considered to be highly concentrated, see the US merger guidelines.
3 According to the parties a route such as the one to and from George, for example, is too small to accommodate more than two competing in-flight caterers.

to be high because, according to evidence provided to them by other players, it was not easy to get premises close to the airport. They were told that the nature of the product and the supply chain necessitates the in-flight caterer to be located on or very close to the airport and the Johannesburg airport, for instance, does not have space to accommodate new players.

The parties submitted a different view. According to them it is not necessary to be present at the airport. LSG, for example, which is the second largest caterer, has premises close to the Johannesburg and Cape Town Airports buy not in the airports.[4] Furthermore, Ground Crew, a new player in the market, has secured premises in Johannesburg Airport.

In light of this we find that entry into the in-flight catering market is not difficult.

According to the parties it is not uncommon for airlines to integrate backwards, some of the major international airlines own in-flight catering services such as Lufthansa, which owns LSG Skychefs and Air France, which owns Serve Air. As is the case with LSG Skychefs, SAA has indicated that it will maintain Air Chefs as a competitor of LSG Skychefs and others because this industry relies on economies of scale to cover its costs. Even a small reduction in the use of its capacity will have a drastic effect on its profits.

The parties therefore argue that a foreclosure strategy would be counter-productive as it would lead to a decrease in Air Chefs sales and thus an increase in its costs and hence SAA's . SAA would thus have increased its own costs, whilst its rivals would be able to turn to alternative sources for supply.

The parties also argued that another class of likely entrants are food and catering companies, many of which are large concerns who could easily adapt their business models to enter if supra –competitive prices were being charged.

Thus, although this is a concentrated market, the merger is unlikely to facilitate a rational foreclosure strategy or to increase barriers to entry, because there are alternative non-integrated players with sufficient capacity in the market, including a real threat of entry by smaller niche players. Secondly, barriers to entry are low.

The Commission, furthermore, points out that countervailing power exists in the in-flight catering market. Customers of the in-flight catering companies are suppliers of airline passenger services, which are mostly large entities that have the ability to exercise a measure of buying power. These customers can easily switch between suppliers since the switching cost in this industry is low. Airlines have told the Commission that poor service would induce a company to change its in-flight catering company rather than price. This is due to the fact that the fixed catering cost per passenger represents a very small part of the total price of an air flight ticket. [5]

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4 The Commission was not aware of this.

5 For example catering costs per passenger represents only 2.5% of the total cost on the Johannesburg-Cape

Taking into consideration all the above factors we agree with the Commission that the merger will not substantially prevent or lessen competition.

Public Interest

The parties submit that the transaction will not give rise to any public interest concerns.

______________ 12 November 2002

N. Manoim **Date**

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