Anticipated acquisition by Flybe Group Limited of the BA Connect business of British Airways plc

The OFT's decision on reference under section 33(1) given on 7 February 2007. Full text of decision published 15 February 2007.

Please note that square brackets indicate figures or text which have been deleted or replaced at the request of the parties for reasons of commercial confidentiality.

PARTIES

1. **Flybe Group Limited** (Flybe) is one of Europe's largest low-cost airlines specialising in serving regional destinations. Its route network encompasses 140 routes from 45 airports spanning nine countries.

2. **BA Connect** is the regional arm of British Airways plc, and offers low fare scheduled services within the UK regions and between UK regional airports and European points. Flybe is acquiring eleven of BA Connect's aircraft[1] and all of the business that is associated with the BA Connect routes, with the exception of Manchester – New York JFK and routes out of London City Airport.

TRANSACTION

3. While the final terms of the transaction are yet to be agreed, the OFT understands that Flybe proposes to acquire the assets of BA Connect (with the exception of the routes described above) in exchange for a 15 per cent share in Flybe.[2] The OFT's analysis is predicated on the transaction being structured in this way.

[1] Four of these aircraft are owned by BA Connect whereas the remainder are subject to an extended lease.
[2] The transaction also involves payments by British Airways plc in relation to BA intergroup loans and pension deficits.

4. The parties notified the transaction to the OFT on 8 December 2006. The administrative deadline expires on 7 February 2007.

JURISDICTION

5. The OFT believes that the business being acquired is an 'enterprise' for the purposes of the Enterprise Act 2002 (the Act) and that as a result of this transaction the enterprises of Flybe and BA Connect will cease to be distinct. The UK turnover of BA Connect exceeds £70 million, so the turnover test in section 23(1)(b) of the Act is satisfied. The OFT therefore believes that it is or may be the case that arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation.

6. EC Council Regulation 139/2004 on the control of concentrations between undertakings is not applicable to this transaction.

MARKET DEFINITION

7. The merging parties overlap in the supply of scheduled passenger air transport services on the following routes:

- Belfast City (BHD) – Manchester (MAN)
- Birmingham (BHX) – Edinburgh (EDI)
- BHX – Glasgow (GLA)
- BHX – Aberdeen (ABZ) (given Flybe's planned entry in March 2007)
- BHX – Geneva (GVA)
- BHX – Hannover (HAJ)
- Southampton (SOU) – EDI, and
- SOU – MAN.

8. In addition, following the decision of the OFT in 2005 to refer to the Competition Commission the proposed acquisition of Exeter Airport by the owners of Bristol Airport (Macquarie Airports Group and Ferrovial Aeropuertos) (the Bristol Airport decision),[3] the merging parties also presented information on those services that potentially overlap because

[3] OFT Decision *Anticipated acquisition of Exeter and Devon Airport Ltd by Macquarie Airports Ltd and Ferrovial Aeropuertos SA* (11 November 2005).

Flybe operates from Exeter and BA Connect operates from Bristol. These services are:

- Bristol (BRS) / Exeter (EXT) – EDI
- BRS / EXT – Paris, Charles de Gaulle (CGD), and
- BRS / EXT – GLA.

Product and geographical market

9. Past decisional practice has considered the relevant starting point for market definition of scheduled passenger air transport services to be origin and destination (O&D) pairs, on the basis of demand-side substitution. While there may in practice be certain routes where passengers (of low cost airlines) are insensitive to the choice of destination, they are unlikely to exceed the critical loss on the domestic and short-haul European routes that are the subject of this merger.

10. The OFT therefore considered the relevant issues in this case within the broad O&D framework. The main issue for consideration was the 'generalised cost' of travel faced by passengers. Passengers generally seek to minimise this cost, which is a function of, amongst other things, price, travel time to the relative locations of embarkation and disembarkation, personal preference and actual O&D journey time.

Substitutability between airports

11. The OFT considered whether the geographic scope should be limited to airport pairs (e.g. BHD – MAN), or extended to cover competition from services from neighbouring airports – for instance to cover air traffic from Belfast (whether using Belfast International (BFS) or BHD) to north west England (either MAN or Liverpool (LPL)). The extent to which flights from neighbouring airports may impose a competitive constraint on services between airport pairs will depend on a number of factors, including the extent to which the catchments of potentially competing airports overlap and the sensitivity of passengers to time travelled to / from the airport.

12. The OFT has considered airport substitutability on a route-by-route basis in the competitive assessment, although there are some common features in relation to the assessment of each airport. In particular, while some passengers fall within the overlapping catchment areas of different airports,

the OFT is required to consider whether the actions of these passengers are sufficient to prevent Flybe from profitably raising its prices post-merger, either through a publicly announced increase in fares or as generated by the yield management system. In this respect, it is relevant that most of the overlaps in this merger occur on short-haul domestic routes, for which flight time (and total travelling time) is relatively short. This will affect the extent of competitive constraint imposed by neighbouring airports, as a potential passenger is unlikely to travel far for a flight of such short duration. In addition, many of the routes have a high proportion of business travellers, who the OFT considers are generally less likely to travel to neighbouring airports (see further discussion below).

Inter-modal competitive constraints

13. Different modes of transport, in particular rail, may also provide substitutable means of travelling between O&D pairs.[4] A passenger's ability to substitute air and rail transport is highly route specific, and depends on the availability of different modes of transport and their comparative characteristics. While alternative modes of transport are considered on a route-by-route basis below, in this particular case there were features common to all rail options on the overlap routes: (1) rail journey time was usually longer; and (2) in many cases, involved indirect train services. The OFT was not provided with sufficient pricing information in order to conduct a useful comparison of relative cost of travel on the two modes of transport.

The relevance of passenger type to analysis of competitive constraints

14. The attractiveness of both neighbouring airports and alternative modes of transport will also be influenced by passenger type. Past decisional practice has tended to distinguish between time-sensitive (generally business) and non-time sensitive (generally leisure) passengers.[5] The merging parties suggested that this distinction has blurred considerably, and was no longer

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[4] See, for example, *British Airways Plc and CityFlyer Express Limited* Cm 4346 (July 1999)., where the MMC (as it then was) found that on certain routes BA CityFlyer and BA also operate in the same market as high-speed rail services, at least in so far as point-to-point travellers were concerned.

[5] For example, see the European Commission's decision in *Air France/KLM* (Case No COMP/M.3280) and the Competition Commission's decision in *Air Canada/Canadian Airlines* Cm 4838 (August 2000).

relevant to their pricing decisions.[6] They suggested that business passengers are becoming more price sensitive, and, moreover that their purchasing habits are now sufficiently indistinct from other passengers such that airline pricing policies are unlikely to be able to price discriminate between less price sensitive customers without the loss of a substantial number of leisure passengers.

15. While it may be more difficult to price discriminate between business and leisure passengers now than it had been prior to the entry of low cost carriers, a number of pieces of evidence suggest that price discrimination against less price sensitive customers might still be possible:

    a) both Flybe and BA Connect continue to offer Economy Plus tickets, and we have received no evidence to dismiss the possibility that a large proportion of passengers buying these tickets are business passengers

    b) one third party has suggested that business passengers will typically book their tickets one week or less before departure. It is not obvious to the OFT that airlines are not able to put up prices closer to the departure date and thus, indirectly, price more highly to business passengers booking in this period

    c) both airlines offer corporate deals to corporate customers. While these deals tend to be network-wide and on the whole non-binding, they may offer the airlines the opportunity to, in effect, price discriminate in relation to business passengers and therefore scope for a post-merger reduction of competition for business passengers, and

    d) certain flights (e.g. early morning, late afternoon/evening) are likely to be predominantly used by business passengers, and are likely to be priced accordingly. A number of third parties highlighted as important the ability to be able to provide early morning departure times to serve the business customer.

16. While business passengers may have become more sensitive to price, the OFT has received no evidence to suggest that journey time or frequency has become significantly less important to business passengers to the extent that they are likely to travel either to neighbouring airports, with

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[6] I.e. they were unable to price discriminate between time-sensitive and non time sensitive passengers.

airlines operating a less convenient schedule, or on alternative modes of transport. The importance of these factors was confirmed by comments received from corporate customers. Therefore, even if there is no direct means by which airlines could identify and as a result discriminate between business and leisure passengers, information on the proportion of customers on a route that are business travellers will influence the level of constraint able to be provided by neighbouring airports and alternative modes of transport. As mentioned above, the OFT considers that the parties may have market information (albeit in approximate terms) as to the proportion of business travellers on its routes that may enable them to make some assessment of the extent of competitive constraint imposed by neighbouring airports and other modes of transport. In this respect the OFT received survey evidence from the CAA to suggest that a high proportion of travellers on each of the overlap routes (with the exception of BHX – GVA) were travelling for the purpose of business.

HORIZONTAL ISSUES

17. As set out above, the merger raises the possibility of unilateral effects on eleven overlapping routes. On seven of these routes, the merger will reduce the number of direct competitors[7] from three to two. On four others, the merger will reduce the number of direct competitors from two to one.

18. The merging parties submit that a combination of direct competition, competition from neighbouring airports and alternative transport modes, and a lack of barriers to entry would be sufficient to constrain Flybe post-merger. Internal documents submitted by Flybe appeared to contradict these submissions. In particular, they suggested that Flybe would obtain benefits as a result of the 'competition upside' and from 'route rationalisation' following the merger. This was in addition to overhead savings and revenue synergies. Flybe explained that these documents were prepared by Flybe very early in the merger process (and with no access to confidential BA Connect data) and as such were not a particularly sophisticated analysis. These documents merely sought to indicate the potential benefits that could accrue from the merger, for example, from the replacement of relatively expensive smaller and inefficient BA Connect aircraft with more efficient aircraft that Flybe had recently ordered. These new aircraft would carry more passengers on the same routes at no extra

[7] Competitors operating from the same airport as one or both of the merging parties.

expense, resulting in a revenue gain for Flybe absent any price effect. Nevertheless, these documents merited a rigorous examination of Flybe's claims in relation to the post-merger constraints by the OFT.

The OFT's overall approach

19. In line with its general policy, the OFT's starting point for the competition analysis in this case was to focus on actual competition on the overlapping routes on a route-by-route basis. For routes where this analysis identified a potential concern, the OFT went on to assess whether entry by new competitors or expansion by existing competitors would be sufficient in time, scope and likelihood to meet any potential concern.

20. As set out below, following this approach, the OFT was ultimately able to conclude that entry/expansion would be sufficient in time, scope and likelihood to alleviate potential concerns on all overlapping routes -- with the exception of the SOU – MAN route -- taking account in particular of both the absence of material entry barriers and the lively history of entry (and exit) in this industry in the last 5 - 10 years. On the SOU – MAN route, concerns regarding the available parking stands at SOU and peak-time runway capacity at MAN lead to a different conclusion on entry.

Actual competition

21. The OFT assessed actual competition on a route-by-route basis, based on the principles of market definition discussed above. Where issues are common to a group of routes they are discussed together.

Belfast – Manchester

22. Flybe and BA Connect are the only two airlines operating on BHD – MAN, both operating similar services (5 weekday rotations[8] a day). The merging parties submitted that bmibaby, operating on BFS – MAN, and easyJet, operating on BFS – LPL, were competitors to the merging parties and should be included as part of the O&D analysis on this route.

23. In relation to bmibaby, the parties submitted that there was substantial evidence to suggest that services from BFS competed with those from

[8] A rotation is an outbound and return service i.e. two one-way flights.

BHD. BFS is located approximately 31 minutes from BHD,[9] although BHD is located substantially closer to Belfast City Centre (12 minutes compared to a journey of 26 minutes). The substitutability of the airports has been considered by the Competition Commission (CC) (then the MMC) in its 1996 report considering a proposed merger between the two airports.[10] The CC concluded:[11]

> 'We are in no doubt that the Belfast airports have sought to compete vigorously under separate ownership. We are also clear that the airlines are influenced in their choice of airport by competition, and that competing airports encourage competition between airlines.'

24. While this investigation was conducted some time ago, the OFT was not presented with any evidence to suggest that we should depart from its conclusion. Further, the parties provided extracts from a recent report completed by the Northern Ireland Affairs Committee[12] suggesting that the airports continue to compete, and a number of third parties confirmed this. The merging parties also provided evidence to show the effect of competing carriers launching services at BFS on other Flybe BHD routes, as well as an analysis of the effect on bmibaby (which operates from BFS) of Flybe's entry onto the BHD – MAN route. On the basis of all the evidence mentioned above, the OFT believes that the services of bmibaby compete with the merging parties in relation to Belfast – MAN.

25. If bmibaby's services from BFS are included in the OFT's analysis, the merging parties' passenger share for Jan – June 2006 would fall to around 57 per cent. While bmibaby currently operates at a lower frequency to the parties, it recently announced that it plans to increase its services to four rotations per weekday. [ ]

26. In relation to easyJet's BFS – LPL service, the parties submitted that MAN and LPL were relatively close geographically (36 minutes driving time). They also referred to a CAA study which suggested that BHD - MAN was affected by competition from easyJet's BFS – LPL service, as well as the

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[9] All travel times have been obtained from the ViaMichelin route planner: www.viamichelin.com

[10] MCC report: Belfast International Airport Limited and Belfast City Airport Limited: A report on the merger contemplation Cm 3068 (9 January 1996).

[11] Ibid at paragraph 1.6.

[12] House of Commons, Northern Ireland Affairs Committee, *Air Transport Services in Northern Ireland* (Eighth Report of Session 2004 – 05). The parties pointed in particular to the evidence of the CAA to the Committee.

recent OFT report on UK airports[13] which suggested that there is an area of overlap between MAN, LPL and Leeds-Bradford Airport, in which all there airports compete.

27. The OFT understands that, given the geographical closeness of the two airports, there will be at least some passengers who see services at LPL and MAN as alternatives, particularly for some longer haul flights. However, the parties provided little in the way of convincing evidence to show that the overlap in catchment areas was sufficient to constrain their pricing on BHD – MAN, particularly for business passengers, and third parties provided little support for the merging parties' submission. Analysis of passenger data provided by the parties suggested that a large majority of MAN passengers come from the Greater Manchester area; the proportion coming from within LPL's catchment area may also largely be accounted for by the fact that MAN is a larger airport, and offers services to a substantially greater number of destinations. Given the lack of evidence on the substitutability of LPL and MAN on this specific route, and the fact that easyJet flies into neighbouring airports at both ends of the O&D pair, the OFT does not consider that easyJet is a significant competitive constraint on the parties BHD – MAN services.

Birmingham – Edinburgh, Birmingham – Aberdeen and Birmingham - Glasgow

28. The merging parties face direct competition from bmibaby on the BHX – EDI and BHX – ABZ routes. In November 2006 bmibaby also announced plans to enter on BHX – GLA in March 2007. Although bmibaby has a lower number of frequencies than each of the merging parties (with the exception of BHX – ABZ, where it will have the same number of frequencies as the proposed Flybe services), it uses higher capacity aircraft.

29. Moreover, bmibaby has announced on 23 November that it plans to increase its services on BHX – EDI and BHX – GLA (each by one rotation). [ ] This is likely to make it a more attractive offering to business passengers. Given these factors, and the relative ease of expansion on the overlap routes on which bmibaby currently competes with the merging

[13] OFT Report: *UK airports: Report on the market study and proposed decision to make a market investigation reference* OFT 882 (December 2006).

parties (see further below) the OFT believes that bmibaby will provide a strong competitive constraint on Flybe post-merger on these three routes.

30. The merging parties also submitted that flights from East Midlands (EMA) placed a competitive constraint on their services from BHX. They noted that the catchment area of the two airports overlapped, and that previous cases had suggested that services from the two airports may be part of the same market for some routes. However, passenger information provided by the parties showed on BHX – EDI and BHX – GLA, passengers living within one hour of BHX by and large used that airport for travel. Business passengers who responded to the OFT request for information suggested that EMA was not a substitute for BHX. Further, bmibaby operates services to EDI and GLA from both EMA and BHX, which suggests that it does not consider these airports to be close enough substitutes for a sufficient number of passengers. On the basis of this evidence, the OFT found that services from EMA would provide at most a weak competitive constraint on Flybe's services from BHX post-merger.

31. The merging parties also submitted that its services from BHX – GLA and BHX – EDI faced competition from Virgin Trains. Potential substitutability of surface for air transport was the strongest for these two routes, although a comparison of journey times suggested that rail journeys were longer than travelling by air, even when taking into account travel to and from an airport, and check-in times. While the parties provided some evidence of advertising their services as an alternative to rail and documents showing the effect on its services from the West Coast rail line, this evidence was not directly related to the overlapping routes. Third party evidence on this point was mixed. In the light of the degree of actual and potential air competition on these routes, it was not necessary to conclude on the extent of competitive constraint posed by rail, which would in any case be weaker than that of direct air competition.

Birmingham - Geneva

32. The BHX – GVA route is strongly seasonal and dominated by the winter ski market. BA Connect is the only scheduled airline offering year-round services on this route, with both Flybe and bmibaby offering winter-only ski services. bmibaby uses larger planes than either of the merging parties, and operates a greater number of rotations than either BA Connect or Flybe during the winter season.

33. The strong emphasis on leisure travellers on this route suggests that both charter flights and (scheduled and charter) flights from neighbouring airports are likely to constrain the parties. Given these competitive constraints and the presence of bmibaby, the OFT does not believe that the merger will raise competition concerns on this route.

Birmingham – Hannover, Southampton – Edinburgh, Southampton - Glasgow

34. On each of BHX – HAJ, SOU – EDI and SOU – GLA, the parties are the only scheduled carriers, making the transaction a merger to monopoly on a strict O&D airport pair basis. The merging parties did not suggest that they did not compete on any of these routes.

35. In relation to SOU, the merging parties operate similar services, although BA Connect has recently moved an aircraft out of SOU and based it at EDI overnight, the result being that they no longer have an early morning SOU – EDI service.[14] The parties argued that their SOU services were constrained by services from London Heathrow (LHR) and London Gatwick (LGW). They suggested that a significant number of passengers on the routes were derived from within the overlap between the catchment areas of SOU and one or other of the London airports. The parties also referred to the OFT's comment in the Bristol Airport decision that EXT and BRS were geographically close, noting that they are a similar distance apart as SOU and the London airports. However, no convincing evidence was provided to show that pricing decisions on these routes were strongly influenced by pricing on services from LHR and LGW.

36. The OFT considered the travel time between SOU and LHR/LGW, as well as the travel times from Southampton city centre to each London airport. The OFT also received information to suggest that a large number of travellers in the SOU catchment area use LHR/LGW, although this did not include a definition as to the extent of SOU's catchment area. Third party views were mixed. While some third parties suggested that neighbouring airports could constrain the parties, a number of third parties, particularly business passengers, suggested that they would not consider LHR/LGW in the event of a price rise in services from SOU. Based on this evidence, the OFT believes that while LHR and LGW may provide some competitive

[14] Following detailed queries, the OFT is satisfied that the decision of BA Connect to relocate its aircraft was made independent of negotiations surrounding the proposed merger.

constraint on Flybe's SOU services post-merger, the OFT was not satisfied that such constraint will be sufficient to alleviate any reduction in competition at SOU as a result of the merger.

37. The merging parties also submitted that SOU – EDI and SOU - MAN faced competition from rail. A comparison of journey times suggested that rail journeys were longer than travel by air, even when taking into account travel to and from an airport and check-in times. Moreover, on the SOU - EDI route, a train service could not provide a departure time that would allow for a morning meeting at the destination point. Direct rail services were also relatively irregular. As a result, the OFT believes that rail provides only a minor competitive constraint on the merging parties services from SOU.

Bristol / Exeter – Edinburgh, Bristol / Exeter – Glasgow and Bristol / Exeter – Paris CDG

38. On each of the overlapping Bristol / Exeter routes the parties only provide more limited competition to one another – as they fly from different airports – than is provided to BA Connect by easyJet at BRS. easyJet offers fewer services than BA Connect on each route, but its frequencies are comparable with Flybe's services at EXT.

39. Despite operating at a frequency that is lower than that of the merging parties combined, easyJet's passenger numbers are at least comparable to the merging parties on BRS / EXT – EDI and BRS / EXT – GLA. Given the larger aircraft it operates, easyJet has the potential to also obtain a significant share of customers on BRS / EXT - CDG. All of these factors suggest that, to the extent that the merging parties competed on the BRS / EXT routes, easyJet can be expected to provide a strong competitive constraint on the merged entity post-merger.

Barriers to entry and expansion

40. As mentioned above, the key part of the OFT's analysis was to consider whether entry by new competitors or expansion by existing competitors would be sufficient in time, scope and likelihood to constrain Flybe post-merger. In considering entry, the OFT recognised that the airline industry has seen a large amount of entry and exit in the last 5 – 10 years as a result of deregulation and the development of low-cost carriers. However,

runway capacity constraints have been cited as barriers in previous cases, and some concerns were raised as to capacity at some of the airports on the overlapping routes.

41. The OFT considered available capacity at each of the airports on the overlapping routes. MAN, CDG and GVA are all 'Level 3 Coordinated' airports, which means that demand exceeds capacity for sufficient periods to the extent that formal procedures for the allocation of available capacity (take off and landing 'slots') are needed. Given the continued presence of sufficient actual competition, entry at CDG and GVA was not considered in detail by the OFT. In relation to MAN, Airport Coordination Limited (ACL) provides slot coordination services. It told the OFT that in Summer 2007 10 per cent of demand could not be accommodated at its required times, and slots were scarce at specific times of day. However, despite these constraints, the OFT received evidence to show that new airlines have managed to obtain slot holdings at MAN even at peak periods. A number of airlines already had a significant presence at MAN, further facilitating potential entry (given the ability to re-assign slots to other routes).

42. Manchester Airports Group Plc (MAG), the operator of MAN, and ACL appears to have an incentive to encourage entry at MAN. MAG and ACL told the OFT that if a new entrant's preferred slot was initially unavailable it would be offered a slot as close as possible to their preferred time in order to ensure that they were not prevented from operating a viable service. This would be in anticipation of maybe being able in subsequent seasons to secure their preferred timings, dependent on the amount of slot 'movement' by other carriers, and the number of slots being surrendered. The OFT is satisfied that, while entry at a specific time of the day may not always be possible at MAN, entry will generally be accommodated to ensure a viable service at MAN can commence.

43. Each of BHX, EDI, HAJ and GLA are 'Level 2 Coordinated' airports. Such airports have runway capacity available throughout the day but may be close to limits at peak times. With the exception of HAJ, ACL facilitates the scheduling at these airports, and addresses any imbalances in runway demand through a process of voluntary schedule adjustment. Evidence provided to the OFT, and in particular by ACL and the airport operators, suggested that airlines wishing to provide services from these airports could generally obtain appropriate landing/departure times. We had no third party complaints regarding entry at these airports, although one competitor

of the parties suggested that they would have some difficulty obtaining early morning slots in some instances. This was consistent with evidence from ACL that there were some shortfalls in runway capacity at peak times, such as between 0700 and 0800 at EDI. However, as with MAN, where such capacity problems arose, the OFT understands that airport operators (through ACL) would attempt to facilitate entry as close as possible to the required time, following which the airline could attempt to obtain their preferred time as it became available. The fact that these are Level 2 Coordinated airports, rather than Level 3, suggests that less capacity problems would arise and that a new entrant is likely to obtain their preferred runway time more quickly than at MAN. The OFT was provided with evidence of recent entry and exit at each of the above airports, as well as a general turnover of runway use at peak times. On the basis of this evidence, the OFT does not believe that there are significant structural barriers to entry at these airports. In addition to this factor, a number of other airlines already have a significant presence at one or more of these airports. This established presence could further facilitate potential entry by reducing the additional cost of introducing further services.

44. The remaining airports forming part of the overlapping routes had no significant runway capacity constraints. However, it was suggested to the OFT by third parties that there was an issue at SOU in relation to parking stand availability. These stands are used by airlines to park their aircraft overnight at SOU. BAA Southampton, the operator of SOU, told us that it currently has capacity for 16 aircraft to park overnight at SOU, 14 on parking stands and two at other parking spots. Of these 16 places, 12 are currently used by Flybe, one by BA Connect, and the remaining three are split between three third parties. [Endnote: Following the decision the OFT discovered that these stand holdings were not, in fact, the current position at SOU, but will be the position for the Summer 2007 season (absent the merger).] The OFT understands that when stands become available they are allocated on a first-come, first-served basis. BAA Southampton told the OFT that two of the parking stands had been developed in the last two years, and that additional stand development scheduled for the next five years included a further 2/3 stands.

45. It was submitted to the OFT that the lack of available parking stands could constrain entry on the SOU – EDI and SOU – MAN routes. The holder of a parking stand was able to operate an early morning flight from SOU, which was claimed to be essential for capturing higher yield business passengers

who require a morning departure. In this regard, it is of note that on the SOU-EDI route, the parties currently operate from different bases, with BA Connect having recently switched to operating the route with an aircraft based at EDI. The competitive constraint lost as a result of the merger is therefore only the operation as provided by BA Connect, and there is no evidence of parking stand shortages at EDI. While some third parties suggested that entry might be more difficult from the EDI end, they did not go so far as to suggest that they would not enter operating an EDI-SOU service.

46. On SOU-MAN, however, BA Connect currently operates from both ends of the route and provides an early morning service at each. Therefore, to replicate the competitive constraint provided by BA Connect before the merger, a SOU stand may well be necessary. While the merging parties suggest that a competing airline could operate from SOU in the morning without a parking stand, this would necessitate basing aircraft at another airport (whether MAN or another base) and then flying to SOU early enough to accommodate business travelers, this 'triangulation' is not common in the industry and is likely to involve substantial costs to the new entrant.

Counterfactual

47. In order to assess whether or not a post-merger substantial lessening of competition is, or may be likely, to occur, it is necessary to consider what the competitive situation would be absent the merger (referred to as the counterfactual). The OFT's substantive guideline suggests that the best guide to the appropriate counterfactual will generally be the prevailing conditions of competition pre-merger.[15] BA Connect submitted that the pre-merger conditions were not the appropriate counterfactual in this case and that the OFT should consider BA Connect's likely future position on the overlap routes when determining the relevant counterfactual. In this regard, BA Connect provided financial data and its outline business plan which it maintained suggested that, consistent with what it argued was past practice in relation to the BA Connect fleet, it would not renew expiring leases on a number of aircraft in 2007. This would give BA Connect the opportunity to withdraw from its most unprofitable routes, which include many of the overlap routes (including both the SOU routes). The parties

[15] See paragraph 3.24 of OFT 516 Mergers – substantive assessment guidance.

therefore submitted that the appropriate counterfactual on which to base the competitive assessment was one where BA Connect operated on only three of the overlap routes.

48. The parties contended that this was not a failing firm defense, but have said instead that this imminent change to the prevailing conditions of competition is nonetheless one to which the OFT must have regard when considering the appropriate counterfactual to the proposed merger situation. The OFT is not persuaded that this is not, in effect, a failing firm defense. In any event, the OFT applies a high evidential standard in circumstances where parties submit that the appropriate counterfactual involves the imminent exit of one of the merging parties.[16] In order for the OFT to accept such a submission, there must be sufficient compelling evidence to substantiate the postulated counterfactual. The standard to be met in this regard is, at least, similar to that required in the context of a failing firm defence, since the nature of the argument, and its consequences for the competitive analysis, are at least similar to those in the context of the failing firm defense.

49. The BA Connect counterfactual submission was provided at a very late stage in the investigation, allowing the OFT very little time to assess its veracity or test the arguments with third parties. While providing financial data and an undated business plan in support of their counterfactual, BA Connect failed to satisfy the evidential burden in relation to the propositions that it and its assets would exit from the overlapping routes without the merger and that this would occur in the near future.[17] Nor did BA Connect demonstrate that it had exhausted all possible avenues in relation to less anti-competitive alternatives (e.g. that there was no other buyer willing to purchase the BA Connect business in the absence of the transaction). In this regard, even if the parties had successfully demonstrated the imminent exit of BA (which they did not) in respect of the route which the OFT had identified a substantial lessening of competition (SOU – MAN), the OFT believes that a preferable competitive outcome may have been for BA Connect to sell this route to a third party or possibly even exit the route without selling the business as either

[16] See paragraphs 3.23 and 3.24 of OFT 516 Mergers – substantive assessment guidance.

[17] See paragraphs 4.37 et seq of OFT 516 Mergers – substantive assessment guidance. Parties claiming this must also demonstrate that there is no possibility of re-organising the business to prevent failure.

outcome (and in particular the former) would have avoided the situation in which BA Connect's parking stand at SOU passed inevitably to Flybe.

50. For the reasons set out above, the OFT concluded that the BA Connect submission regarding the appropriate counterfactual was not ultimately relevant to the competitive assessment in this case.

THIRD PARTY VIEWS

51. Third parties concerns are largely dealt with in the analysis above. The majority of third parties supported the view that the airline industry was relatively dynamic and that the potential for entry/expansion would sufficiently constrain the parties. Some customers were concerned about the reduction in competition on particular routes, although most also acknowledged alternative modes of transport and/or entry possibilities. Some competitors expressed concern regarding access to airports and the ability to compete on frequency.

ASSESSMENT

52. The anticipated acquisition by Flybe of BA Connect brings together two of the UK's largest regional airlines. The OFT considered the 11 overlapping routes on which the parties provided services from similar or neighbouring airports. The OFT considered both actual and potential competition on a route-by-route basis, analysing factors such as the extent of actual competition on the airport O&D pair and the competitive constraint provided by services at neighbouring airports, alternative modes of transport, and potential entry. In considering these competitive constraints the OFT was aware that a large proportion of passengers on each of the overlap routes (with the exception of BHX – GVA) were travelling for business purposes.

53. In summary, for all of the overlapping routes in question -- with the exception of SOU – MAN (see below) -- the OFT's analysis revealed that entry/ expansion would be sufficient and timely to counter any reduction of direct competitive constraint as a result of merger.

54. In addition, the merged entity would face direct actual competition on most routes (or, in the case of BHD – MAN, competition from an airline at a

competing airport) and the structure and practices of the airline market meant that the reduction of competitors from three to two on each of these routes unlikely to be a cause for concern. On each of these routes, there were no significant restrictions on the competitor airline expanding its services to further compete with the merged entity.

55. A more detailed summary of the OFT's route-by-route assessment of the post-merger competitive constraints on Flybe in relation to the overlapping routes is as follows:

- **BHD – MAN:** on the basis of the evidence regarding competition between BFS and BHD, bmibaby will continue to pose a significant competitive constraint on Flybe post-merger. In addition, there are no significant barriers to entry or expansion in relation to BHD, BFS and MAN and there is a lively history of recent entry in this industry. The OFT therefore does not believe that the merger will raise competition concerns on this route.

- **BHX – EDI, BHX – ABZ and BHX – GLA:** while Flybe and BA Connect are (or, in the case of BHX – ABZ[18], will be) direct competitors on these routes, bmibaby is also present. bmibaby has shown both the ability and intention to expand on the routes to compete with Flybe post-merger. In addition, there are no significant barriers to new entry on these routes and there is a lively history of recent entry in this industry. The OFT does not therefore believe that the merger will raise competition concerns on these routes.

- **BHX – GVA:** Flybe is only a marginal competitor on this route, and is more than matched by the presence of bmibaby. The strong emphasis on leisure travellers on this route suggests that both charter flights and flights from neighbouring airports (given the flight time) are also likely to constrain the parties on this route. Given these competitive constraints the OFT does not believe that the merger will raise competition concerns on this route.

- **BHX – HAJ:** this is a very thin route (in terms of passenger numbers), on which Flybe has only recently commenced operating. While the parties are the only direct competitors, we have not received any evidence to suggest that there are substantial barriers to entry on this route, and in particular that there are any significant structural barriers at either airport. In addition, a number of airlines have a substantial presence at either BHX or HAJ, such that, given the lively history of recent entry in this industry, entry may be

[18] Entry was planned for March 2007.

considered sufficient in time, likelihood and scope should Flybe increase price or reduce service levels following the merger. The OFT does not therefore believe that the merger will raise competition concerns on this route.

- **BRS / EXT routes:** Flybe and BA Connect currently compete from different airports on each of the BRS / EXT routes, and easyJet is a significant competitor to BA Connect at BRS. Given this actual competitive constraint, the OFT does not believe that the merger will raise competition concerns on these route.

- **SOU – EDI, SOU - MAN:** on each of the SOU routes the parties are the only direct competitors. Each operates similar services, although a significant difference between the frequency of services is that BA Connect bases its aircraft on the SOU – EDI route at EDI, meaning it does not have an early morning departure at SOU for this route. On the basis of the evidence before it, the OFT found that any competitive constraint from LHR / LGW and alternative modes of transport would not be sufficient to outweigh any loss of direct competition that might be considered to arise on either of the SOU routes. The OFT also found that there were potential issues with entry/expansion on the SOU routes, in particular the absence of available parking stands.

  However, in relation to the SOU – EDI route, the evidence did not support the conclusion that the absence of available parking stands represented a material barrier to replicating the constraint currently provided by BA Connect on this route. BA Connect's existing SOU – EDI service operates from an EDI base without the use of a parking stand at SOU and while certain third parties suggested that entry might be more difficult from the EDI end, they did not suggest that this was sufficient to deter entry, and hence replicate the competitive constraint provided by BA Connect on SOU - EDI.

  In contrast, in relation to the SOU – MAN route, BA Connect's decision to continue to base an aircraft at both the SOU and MAN ends on this route suggested an early morning flight (and therefore a parking stand) from SOU was critical to this route. This indicates that the absence of an available parking stand at SOU could be a material barrier to entry on this route. The OFT therefore believes that it is or may be the case that the merger will lead to substantial lessening of competition on the SOU – MAN route.

56. For the reasons set out above, the OFT believes that it is or may be the case that the merger may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom.

EXCEPTIONS TO THE DUTY TO REFER

Customer benefits

57. Section 33(2)(c) of the Act provides[19] that the OFT has a discretion not to refer a merger to the Competition Commission where there are clear and, in the case of cost savings, quantifiable customer benefits, which will be sufficient to outweigh the competition detriments caused by the merger.[20] Such customer benefits include lower prices, greater innovation, greater choice and higher quality.

58. Flybe argued -- at a very late stage in the process -- that the merger would give rise to substantial customer benefits that would outweigh any detriment arising from the merger. These benefits included lower prices for customers of the merged entity across the whole of its network as a result of the introduction of the low cost airline model to the routes currently operated by BA Connect. In particular, Flybe identified that this would be the first time that a low cost carrier would operate on a regional basis to key European destinations. Flybe also suggested that the merger would ensure that BA Connect's airline slots at major European airports would be maintained by a UK (low cost) carrier, which might otherwise be lost if BA Connect simply withdrew from these routes.[21]

59. The parties arguments on customer benefits as a result of the introduction of the low cost airline model potentially seem plausible -- particularly given that the OFT's competition concerns relate to only one of a large number of BA Connect routes that Flybe will acquire following the merger. However, the OFT was unable to exercise its discretion not to refer the merger under

[19] See OFT 516 Mergers – substantive assessment guidance at paragraphs 7.7 et seq.

[20] Additional requirements are that the claimed customer benefits will materialise within a reasonable period of time and such benefits would be unlikely to arise without the merger.

[21] Flybe also submitted the use of state of the art, highly fuel efficient aircraft, which are larger than those currently operated by BA Connect, would produce environmental benefits. However, as such environmental benefits are not specific to airline customers and notoriously difficult to quantify, they cannot be considered to be a customer benefits within the meaning of section 33(2)(c) of the Act and certainly not without substantially more evidence than was provided by Flybe.

section 33(2)(c) in this instance since Flybe provided little or no concrete evidence of likely price reduction (and certainly insufficient evidence to meet the clear and quantifiable standard) and the claimed benefits in relation to increased customer choice and quality are difficult to assess. Finally, as mentioned above, given that Flybe only provided arguments relating to customer benefits shortly before the OFT was required to made its decision in this case, this did not allow sufficient time for the benefits to be properly assessed or tested.

Undertakings in lieu

60. Where the duty to make a reference under section 33(1) of the Act applies, pursuant to section 73(2) of the Act the OFT may, instead of making such a reference, and for the purpose of remedying, mitigating or preventing the substantial lessening of competition concerned or any adverse effect which has or may have resulted from it or may be expected to result from it, accept from such of the parties concerned undertakings as it considers appropriate.

61. The OFT has therefore considered whether there might be undertakings in lieu of reference which would address the competition concerns outlined above. The OFT's Mergers Substantive Assessment Guidance states that, '*undertakings in lieu of reference are appropriate only where the competition concerns raised by the merger and the remedies proposed to address them are clear cut, and those remedies are capable of ready implementation*.'[22]

62. Flybe indicated to the OFT that in order to remedy any substantial lessening of competition identified by the OFT and to avoid a reference to the Competition Commission, it would be prepared to offer undertakings in lieu to remedy any perceived harm at SOU. These undertakings – which were in addition to the 'slots'[23] which Flybe had indicated it might unilaterally vacate at SOU - included:

   a) a commitment to deploying a 118 seater aircraft on the first northbound departure on the SOU – EDI route, to ensure continued high capacity on

[22] Para 8.3.
[23] Technically not all 'slots' but used here as shorthand for runway departure/arrival times.

the route, or provide any other capacity or frequency guarantees that might be required

b) vacating a parking stand at SOU to allow a new entrant onto the SOU – EDI or SOU – MAN route, provided that the potential competitor has made reasonable efforts to secure one but has failed to do so., and/or

c) capping its fares on these two SOU routes for a period of one year.

63. The OFT believes that the release of a parking stand would be a clear cut remedy and could be capable of ready implementation. Further, we consider that this remedy clearly addresses the competition concerns which it has identified as arising from the merger, as it eliminates the primary barrier to entry in relation to the SOU – MAN route. The remedy is largely structural in nature, and is consistent with previous European Commission decisions[24] on mergers and joint airline alliances, which offer slot divestment in order to encourage entry. Furthermore, the remedy will only be required if the new entrant has been unable to obtain a parking space through other means (e.g. expansion of parking spaces at SOU or replacement of an exiting airline). The other undertakings offered by Flybe -- that is to deploy a 118 seater aircraft on the SOU - EDI route and fare caps -- are not necessary to remedy the OFT's concerns.

64. In light of the above, on the information currently available, the OFT has decided to exercise its discretion under section 73(2) of the Act to negotiate undertakings in lieu of reference based on Flybe's offer to vacate a parking stand at SOU.

DECISION

65. The OFT has therefore decided to refer the anticipated acquisition by Flybe of BA Connect to the Competition Commission pursuant to section 33 of the Act. However the OFT's duty to refer is suspended because the OFT is considering whether to accept undertakings in lieu of reference from Flybe pursuant to section 73 of the Act.

66. This merger will therefore not be referred to the Competition Commission under section 33(1) of the Act.

[24] See for example M.3770 Lufthansa / Swiss and M.3280 Air France /KLM.