

RYANAIR'S ACQUISITION OF A MINORITY STAKE IN AER LINGUS

RYANAIR'S SUBMISSION ON THE SLC TEST

1. Executive Summary

- 1.1 Ryanair's primary case is that the OFT has no jurisdiction to investigate its minority stake because the OFT is out of time in asserting jurisdiction and, in any event, Ryanair does not have material influence over Aer Lingus. Ryanair has prepared this paper on a precautionary basis to explain why, even if the OFT has jurisdiction, there is no realistic prospect that a substantial lessening of competition ("SLC") has resulted, or may be expected to result.
- 1.2 In investigating the SLC issue, it is necessary to take account of the legal and economic context including, in particular, the size of Ryanair's stake, the nature of the rights attached to it, and the value of the stake compared with Ryanair's market capitalisation – it accounts for around 1 per cent. of Ryanair's value.¹ An important aspect of the legal analysis is that the acquisition of the minority shareholding has to be seen as an investment with two possible outcomes: the first is that the politically-driven opposition by the Irish Government to Ryanair's acquisition of legal control of Aer Lingus will finally evaporate, the Irish Government will see the sense of having a single Irish airline, and the airline passenger market will be seen by the European Commission as more than capable of resisting any possible adverse effects from the merger, with or without commitments. The second is that if there is a willing buyer prepared to offer a reasonable price, Ryanair will consider it.
- 1.3 Any suggestion that Ryanair's minority stake has resulted, or may be expected to result, in an SLC needs to overcome, as a threshold issue, the fact that the evidence over the past five years demonstrates comprehensively that Ryanair has not used its minority stake to create a lessening of competition. This is entirely consistent with Ryanair's rationale for acquiring and retaining its stake.
- 1.4 Nevertheless, Ryanair follows the conventional route of identifying theories of harm for investigation. This paper discusses three.
- 1.5 The first theory of harm is that Ryanair has in fact competed, or is incentivised to compete in the future, less strongly against Aer Lingus, since increasing Aer Lingus' profits might increase the value of Ryanair's shareholding. Normally this theory of harm would be framed around the impact of competition from Ryanair on Aer Lingus' ability to pay dividends. However, Aer Lingus has a policy of not paying dividends,² and, despite requests from Ryanair to do so, there is no indication that this strategy will change in the foreseeable future. Accordingly, we have instead focused on the

¹ Moreover, Ireland now accounts for only around 7 per cent. of Ryanair's business.

² Despite making large payments to individual shareholders (the Employee Share Ownership Trust ("ESOT") received over €30m in December 2010).

possibility that Ryanair might capture the benefits of the strategy through increases in the value of its shareholding. We conclude that such a concern can be ruled out for the following reasons.

- (a) The OFT is, of course, increasingly using "Indicative Price Rise" ("**IPR**") calculations to provide a better proxy of merger effects. In its decisions, the OFT has commonly ruled out competition concerns in markets in which the model predicts a price increase of less than 5 per cent. Accordingly, Ryanair's economic advisers, Oxera, have carried out an IPR calculation, taking account of the fact that Ryanair has only a minority stake in Aer Lingus. Their work shows that, even if Ryanair had the information about Aer Lingus' route-by-route profitability necessary to set a profit maximising price, nevertheless price rises of 5 per cent. or more are *not* predicted and, accordingly, in line with the OFT's consistent approach, the first theory of harm can be ruled out with confidence.
- (b) Moreover, even if the 5 per cent. threshold were crossed in the model, this is not a realistic proxy because Ryanair lacks the *ability* to implement a strategy of profitably raising prices as it does not have access to the necessary information, namely Aer Lingus' profit margins on the routes in question. This imperfect information means that, in reality, any price increases would be lower than those predicted by the model. Further, Ryanair would have no *incentive* to sacrifice 100 per cent. of the profits it could have earned by competing hard against Aer Lingus in order to enhance the value of its shareholding in Aer Lingus because the mechanism through which its stake would increase in value is so uncertain: even if the increased profitability of the route did not attract entry or expansion from other airlines, Aer Lingus might well spend any increased profits competing more aggressively against Ryanair or on projects which in Ryanair's view reduce shareholder value (e.g. buying aircraft at the top of the cycle or supporting the construction of an unnecessary new terminal at Dublin airport).
- (c) There is no evidence that Ryanair's minority stake has affected entry or exit decisions by either party.
- (d) Finally, the first theory of harm is disproved by the substantial evidence of increased and intense competition between Ryanair and Aer Lingus at Belfast, Shannon, Cork and Dublin airports since 2006 including Ryanair's board minutes and papers, Ryanair's press releases, Ryanair's adverts and the history of dealings between the two companies. Moreover, there is scope for further increased competition in future: Ryanair has offered the Dublin Airport Authority ("**DAA**") and Irish Government growth of 5 million passengers at Irish airports (even though, if accepted, this would clearly reduce the value of its shareholding in Aer Lingus). Finally, Aer Lingus' share price has fallen from a peak of €3.275 per share during the first six months of trading to under €0.60 in 2011, which is consistent with it facing strong competitive constraints.

1.6 The second theory of harm is that Ryanair's ability to block a special resolution and/or a scheme of arrangement may have resulted, or may be expected to result, in an SLC.

Such a concern can be ruled out: Ryanair was soundly defeated when it opposed the one resolution in the last five years that concerned Aer Lingus' commercial strategy (the US\$2.4 billion aircraft order) and Aer Lingus can readily fund its commercial strategy from its significant available gross cash of €25 million or via external financing and does not need a waiver of pre-emption rights or a takeover in order to implement its strategy. Further, Ryanair has repeatedly made clear that it is open to offers for its stake.

- 1.7 The third theory of harm is that the acquisition by Ryanair of a minority stake may have increased, or may be expected to increase, the likelihood or intensity of coordinated effects in markets for air passenger services.
- (a) It follows in particular from the evidence summarised in para. 1.5(d) above that there is no evidence of any such coordination having occurred to date in the market. Since Ryanair has held its stake for five years and there are no recent or expected material changes in circumstances, the possibility of coordinated effects occurring in the future can be ruled out.
 - (b) In any event, the relevant passenger airline markets are not conducive to coordinated effects in the light, in particular, of the complexities of pricing and the ease of competitive entry and launching new routes.
 - (c) Ryanair's minority cross-shareholding does not alter the normal analysis: Aer Lingus' relationship with Ryanair is at best dismissive and both parties ensure that they comply with stock exchange and competition rules regarding price sensitive and commercially sensitive information. As a result, Ryanair's stake does not give rise to any contact between competitors of the sort that might lead either to alter its commercial strategy.

There is therefore no evidence of historic coordination and no realistic prospect of coordination in the future.

- 1.8 The three theories of harm are discussed in sections 5 to 7 below. Before addressing them, Ryanair makes some introductory comments about the application of the SLC test in this case and the transaction rationale (section 2), discusses market definition and market shares (section 3) and identifies actual and potential competitors (section 4).

2. **Introduction**

(a) The SLC Test

- 2.1 The OFT has a duty to refer when it believes that there is a realistic prospect of an SLC³ but, in line with the Court of Appeal's judgment in *IBA Health*,⁴ "*The OFT's judgment on whether there is a realistic prospect of an SLC will take due account of*

³ Merger Assessment Guidelines, OFT1254/CC2 (Revised), September 2010 (the "**Guidelines**"), para. 2.6.

⁴ *Office of Fair Trading v. IBA Health* [2004] EWCA Civ 142.

the evidence available to it at the time of its decision."⁵ In this case, the facts are unusual because:

- (a) Ryanair has held its minority stake for five years; and
- (b) Aer Lingus is very keen for the UK competition authorities to require Ryanair to sell some or all of that stake to free itself from what its legal advisers have wrongly claimed is material influence from Ryanair.⁶ Aer Lingus therefore has every incentive to make available to the OFT any information that might lead the OFT to find a realistic prospect of an SLC.

The availability of such extensive evidence – including *ex post* evidence over five years demonstrating that the minority stake has had no effect on competition in the market – is therefore very important in applying the "*realistic prospect*" test. In short, the OFT is much better able to rule out competition concerns when it has real world historic evidence of the effects of the merger than in an anticipated or recently completed merger when the analysis is entirely or largely prospective and therefore (necessarily) somewhat speculative and uncertain. This investigation gives the OFT a unique opportunity to review the transaction's effects over a period of five years. This *ex post* evidence demonstrates the absence of SLC.

(b) Transaction Rationale

- 2.2 Ryanair acquired most of its minority stake as part of its original 2006 offer to acquire sole control within the terms of the EC Merger Regulation ("**ECMR**"). Ryanair's first attempt to acquire Aer Lingus was blocked by the European Commission's decision of 27 June 2007 (the "**2007 Decision**").
- 2.3 Ryanair subsequently increased its minority stake as it believed that it would eventually be able to bid successfully for Aer Lingus, obtaining approval from the European Commission under the ECMR (perhaps subject to commitments) and agreement from the Irish Government to sell its stake to Ryanair. Consistent with that strategy, Ryanair made a second offer for Aer Lingus in 2008, but the bid was withdrawn in January 2009 when the Irish Government declined Ryanair's offer.
- 2.4 Ryanair has retained its minority stake as it believes that it will eventually be able either:
 - (a) to make a successful bid for Aer Lingus, in particular since Dublin airport has increased its capacity whilst demand has fallen since the 2007 Decision⁷ and the Irish Government has an increased incentive to realise the value of its minority shareholding in the light of its debt crisis; or
 - (b) [CONFIDENTIAL].⁸

⁵ Guidelines, para. 2.7.

⁶ The submissions from Aer Lingus' advisers are at odds with public statements by Aer Lingus' senior management as noted in Covington & Burling's letter of 18 August 2011. In any event, the purpose of merger control is not to protect companies from perceived activism by minority shareholders.

⁷ This point is developed in section 4 below.

⁸ [CONFIDENTIAL].

3. Market Definition and Market Shares

3.1 Ryanair has carried out an initial investigation of potential market definitions and the market shares arising from them. This work indicates that the OFT's investigation should focus on whether an SLC may have resulted, or may be expected to result, on a relatively small number of routes from the UK to Ireland – accounting for relatively small proportions of each of the parties' networks – where the parties are currently the only actual competitors. Other routes are of limited or no significance because there is either little or no competition between Ryanair and Aer Lingus on the route or there is sufficient actual competition from other airlines. The analysis can be summarised as follows.

(a) There are five routes on which Ryanair and Aer Lingus⁹ overlap between the UK and Ireland where the *airport pair* is the same. On one of these, London Gatwick–Shannon, Aer Lingus has announced plans to terminate its service from 11 September 2011¹⁰ and so there is an historic but no prospective overlap. On three, Ryanair and Aer Lingus face no competition from another airline at either an airport or a city pair level, or on any reasonable potential market definition and the combined market share is therefore 100 per cent.:

- (i) Birmingham–Dublin;
- (ii) London Gatwick–Cork; and
- (iii) Manchester–Dublin.

On the fifth route (Gatwick–Dublin), both parties are present, but passengers can also use bmi's Heathrow–Dublin service.¹¹

(b) There is another set of *city pair* routes where previous decisions suggest that there is a relevant overlap, but Ryanair believes that a fresh review ought to lead to a different conclusion. If there is a relevant overlap on these routes, then the parties have combined shares of 100 per cent. The routes are:

- (i) London Luton–Dublin;
- (ii) London Luton–Knock;
- (iii) London Stansted–Dublin;
- (iv) London Stansted–Cork;
- (v) London Stansted–Knock; and
- (vi) London Stansted–Shannon.

(c) Ryanair submits that the following categories of routes can effectively be disregarded on the grounds that there is either little or no competition between Ryanair and Aer Lingus or there is sufficient competition from other airlines:

⁹ Ryanair believes that overlaps between Ryanair and Aer Lingus' franchisee, Aer Arann, should be disregarded for reasons given in [Annex Removed].

¹⁰ See <http://www.aerlingus.com/travelinformation/weboffersfromuk/flytoshannon>.

¹¹ This is true whether or not Gatwick–Dublin is defined as part of a market that includes Heathrow–Dublin.

- (i) Several of the airports in the south-west of Ireland are within two hours drivetime of each other, but the locations of population centres relative to the airports means that they are very unlikely to compete actively with one another because the majority of people live near to one airport or another, with few people located roughly equidistant from two airports.
- (ii) Whilst there are arguably overlaps between Ryanair and Aer Lingus on four routes from Derry or Belfast (to Alicante, Faro, London and Tenerife), there is a wealth of competition on these routes, with easyJet competing on three of them from Belfast International, Thomas Cook on two of them, and Jet2 on two of them. Even if Derry and Belfast are found to be in the same geographic market, there is intense competition, for example with at least two alternative competing airlines on the Alicante, Faro, and London services.
- (iii) There is also strong actual competition on the London-Malaga route, with BA and easyJet also offering Malaga–London services.

3.2 The detailed work behind these conclusions is included in the following Annexes:

[Annex Removed]

4. Actual and Potential Competitors

4.1 In considering the three theories of harm summarised in section 1 above and described in more detail in sections 5 to 7 below, it is relevant to understand the extent of the actual and potential competitive constraints faced by Ryanair and Aer Lingus. In particular, any incentive Ryanair may have to "soft-pedal" against Aer Lingus (the first theory of harm) is reduced if such soft-peddling would or might lead to entry or expansion by rivals. Similarly, any incentive Ryanair may have to damage Aer Lingus' competitiveness using Ryanair's rights as a minority shareholder (the second theory of harm) is reduced if such damage would or might lead to entry or expansion by rivals. Finally, the external stability of a coordinated outcome (the third theory of harm) depends on competition from outside the coordinating group.¹²

4.2 This section is structured as follows. First, we identify the actual and potential competitors. Secondly, we show that entry barriers are low and that there is a credible threat of entry. Thirdly, we demonstrate that the absence of observed recent entry is due to the intensity of competition and the falling demand on the relevant routes and not to entry barriers.

(a) Actual and Potential Competitors

4.3 Airlines are distinguished primarily by their operating model (point-to-point vs. network carriers) and by the level of fares (low-, mid- and high-fares).

- (a) Point-to-point carriers, such as Ryanair, offer direct services from an originating airport to a destination airport without connecting flights. Network

¹² The Guidelines, para. 5.5.9(c).

carriers focus on a "hub-and-spoke" business model, which involves feeding a major "hub" airport with services from other "spoke" airports. Aer Lingus has opted for an "intermediate model":¹³ it provides some point-to-point services, but it also provides connecting services from Dublin, Heathrow and New York airports, therefore offering onward connections along the lines of the hub-and-spoke model, and operates certain long-haul routes.

- (b) Level of air fares: Ryanair is a low-fares airline and does not target customers who value additional services such as seat allocation, flexible fares, business lounges, and frequent flyer programmes. In 2010, Aer Lingus abandoned a low-fares approach and has positioned itself as a "value carrier", i.e. a mid-fares operator.¹⁴

4.4 In recent years, a number of successful point-to-point low- and mid-fares carriers have emerged in Europe creating a sizeable pool of actual competitors and potential entrants that actively seek opportunities to join profitable routes and are able to divert aircraft to new routes very quickly. The following independent point-to-point carriers are already active in Ireland and/or the UK and can easily expand their activities:

- (a) easyJet. easyJet is a low-fares, point-to-point, airline operating on a pan-European basis and maintaining an extensive network of bases and 196 aircraft which serve 125 destinations. In 2010, it carried 48.8 million passengers and had revenues of £2.97 billion. In its business model and scale of operations, it is very close to Ryanair. easyJet maintains a strong presence at Belfast International airport, flying to 16 destinations, 10 of which are located in the UK mainland. In *easyJet / GB Airways*, easyJet submitted that it "*constantly reviews its route mix to determine whether there are profitable opportunities available*".¹⁵ It is therefore a potential entrant on to UK-Ireland routes, particularly if it judged that Ryanair and Aer Lingus would not compete effectively because Ryanair was pursuing a "soft-peddling" strategy or the two airlines were coordinating.
- (b) Flybe. Flybe is, much like Aer Lingus, a medium sized, medium-fares airline. It is characterised by a multi-base, point-to-point business model. With a fleet of 71 aircraft it serves 76 destinations. Given its strong position in the UK market (particularly since its acquisition of BA Connect in March 2007), its current presence in Dublin airport and its existing Dublin-Exeter service, it is well positioned to compete extensively with Ryanair and Aer Lingus.
- (c) Jet2. Jet2 has a fleet of 38 aircraft and serves over 50 principally leisure destinations. It has a medium-fares, point-to-point, multibase business model and operates a successful route in Ireland from Cork to Newcastle. Jet2 has a base at Belfast International airport, flying to eight destinations, two of which are in the UK mainland.

¹³ See Aer Lingus Annual Report, 2010, p. 6, Table, row "Network connectivity". Aer Lingus contrasts its position with low cost carriers and full service flag carriers, stating: "*Appropriate connectivity offering at selected hubs Emphasis on partnerships and connectivity to other airlines.*"

¹⁴ Aer Lingus explains the background to its change in strategy in its Annual Report, 2010, p. 6.

¹⁵ *EasyJet / GB Airways*, para. 31.

- (d) *Air Berlin*. Air Berlin, a German airline, provides point-to-point services, but has some characteristics of a network airline. It operates a fleet of 170 aircraft, both long and short haul, and flies to 163 destinations mainly in Europe. Air Berlin is active on the Irish market, flying to three Austrian destinations from Shannon. Whilst Air Berlin has recently announced a retrenchment to address its financial difficulties, it remains a significant and experienced operator with a large fleet and every incentive to deploy that fleet on the most profitable routes. In the light of its established presence in Ireland and at the London airports it is therefore a potential competitor to Ryanair and Aer Lingus on the UK-Ireland routes.

4.5 Following a wave of consolidation in the industry, three network mega-carriers, Air France-KLM, IAG (i.e. British Airways and Iberian), and Lufthansa, lead the European market. These network carriers have the ability and the incentive to expand to new routes:

- (a) *Air France-KLM*. In FY 2010, the Air France-KLM group transported 71 million passengers and had revenues of €23.6 billion. It has a significant presence in continental Europe operating out of two hubs in Paris CDG and Amsterdam. It is a member of the Skyteam alliance. In Ireland, it is present via its wholly owned subsidiary Cityjet, headquartered in Dublin.¹⁶ Cityjet operates short haul aircraft on behalf of Air France-KLM on several routes, including Dublin-London City, Dublin-Luxembourg and Dublin-Pau.
- (b) *IAG*. IAG was formed in January 2011 by the merger of British Airways ("**BA**") and Iberia. In 2010, the merged airlines transported a combined total of 58 million passengers and had consolidated revenues of €13.8 billion. BA and Iberia are members of the Oneworld alliance. IAG's principal hubs¹⁷ are London Heathrow and London Gatwick. It is also strongly positioned in other UK airports such as Birmingham, Edinburgh and Manchester. BA and Aer Lingus have a codeshare agreement for routes between Dublin, Cork, Belfast and Heathrow. IAG has both the financial resources and managerial expertise to enter routes to Ireland if and when it chooses.
- (c) *Lufthansa*. In 2010, German group Lufthansa transported 90 million passengers and had revenues of €27.3 billion. As part of its expansion strategy, Lufthansa has recently acquired Swiss, BMI, SN Brussels Airlines, Germanwings, and Austrian Airlines. It is a member of Star Alliance. BMI operates a fleet of 47 aircraft mainly on routes from and to the UK, including a number of Ireland-UK routes (including London Heathrow to Dublin) and provides Lufthansa with an enhanced platform to compete, particularly in the UK-Ireland market. Germanwings is a low-fares airline that competes head-to-head with Ryanair; it operates a fleet of 35 aircraft and offers 14 routes from Dublin, many of which are to destinations outside Germany (such as Zurich, Venice and Dubrovnik).

¹⁶ KLM has a codeshare agreement with Aer Lingus for services between Dublin and Amsterdam and Cork and Amsterdam.

¹⁷ In addition to Madrid.

- 4.6 Because their business model is similar to that of Ryanair,¹⁸ low-fares carriers exercise a particularly strong competitive pressure on Ryanair. Conversely, following Aer Lingus' repositioning as a medium-fares operator, both the network carriers and the low-fares carriers are reasonably close competitors to Aer Lingus. Thus, when considering the scope for Ryanair and Aer Lingus to dampen competition themselves (whether through Ryanair "soft-peddalling" or coordinated effects¹⁹) all of the airlines identified in paragraphs 4.4 and 4.5 above are important actual or potential constraints.
- 4.7 Contact information for the competitors identified in this section (b) is given in [Annex Removed].

(b) There is a Credible Threat of Entry Due to Low Entry Barriers

- 4.8 The airline industry is generally characterised by low barriers to entry.²⁰ Low sunk costs make it feasible for existing airlines to enter, expand, contract and/or exit from individual routes. This is because virtually all of the assets required to operate an airline can readily be re-deployed to other routes or leased out in response to changing market circumstances. The EU exhibits especially low barriers as a result of deregulation and aircraft can be shifted quickly from one route to another to take advantage of profitable opportunities. Tickets for new routes can be advertised and distributed via the Internet without incurring significant costs.
- 4.9 The OFT has in the past cleared mergers between airline operators resulting in high combined market shares after finding that entry barriers were low and the parties' market power was constrained by potential entrants.²¹
- 4.10 In *Flybe / BA Connect*, 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*". The OFT found that the only potential barrier to entry in the airline industry arose from runway capacity constraints.²² It relied on the airport classification established by the European Airport Coordinators Association. The OFT concluded that only "Level 3 Coordinated" airports experienced capacity constraints.²³ According to this classification, the airports in the following cities in the UK and Ireland are "Level 3 Coordinated": London (other than Luton), Dublin, and Manchester.²⁴ Other relevant airports are Level 2 or 1 and, therefore, do not experience any capacity constraints. Ryanair also believes that there is a credible threat of entry in London, Dublin and Manchester:
- (a) In London, there is substantial off-peak capacity available, particularly at Stansted and Gatwick, and peak-time slots also appear regularly at London airports other than Heathrow. Further, potential competitors with existing slots in London airports could easily re-allocate these slots to UK-Ireland flights if the relative profitability of such flights rose as a result of a reduction in

¹⁸ [CONFIDENTIAL]

¹⁹ See sections 5 and 7 below.

²⁰ Indeed, low cost airlines are the most commonly cited example of a contestable market.

²¹ See, e.g., *EasyJet Airline Company Limited / GB Airways Limited*, para. 28.

²² *Flybe / BA Connect*, para. 40.

²³ *Flybe / BA Connect*, paras 41-44.

²⁴ <http://www.euaca.org/FTableList.aspx?list=6>

competition between Ryanair and Aer Lingus. Finally, Luton is only Level 2 Coordinated.

- (b) Similarly, several major actual or potential competitors (including IAG/BA, easyJet, Flybe, as well as suppliers such as Thompson and Monarch) hold slots at Manchester airport that could be re-allocated to UK-Ireland flights if the relative profitability of such services increased and airlines flying from Manchester compete with those using Liverpool and Leeds, which are not congested, and provide a ready opportunity for entry or expansion.
- (c) With respect to Dublin, the "Level 3" classification is outdated and does not take into account recent capacity expansions or reductions in traffic. In 2010, Dublin airport opened a new terminal (Terminal 2), adding 19 new air bridges and providing for extra capacity of 15 million passengers per year. The Dublin Airport Authority also completed Pier D at Terminal 1, adding 12 new gates, parking for up to 14 aircraft and additional capacity of 10 million passengers per year. Ryanair believes that, following the completion of Terminal 2 and Pier D, Dublin airport now has a total capacity of some 55 million passengers per year.²⁵ However, the airport is operating at only one-third of its capacity, handling only 18.4 million passengers in 2010.²⁶ It is clear that substantial runway capacity is now available at Dublin airport and can be used by new entrants, including for services at peak times.

4.11 In the 2007 Decision, the European Commission found that entry was hindered by the fact that both Ryanair and Air Lingus had large operations ("**bases**") in Dublin.²⁷ However, the concerns that the EU Commission identified in 2007 about the effectiveness of competition from rivals with a base *at the other end of the route to/from Dublin* (termed a "destination-based competitor") do not operate today as a significant deterrent to entry on UK-Dublin routes.

- (a) The Commission identified an "*asymmetry of origination on a number of the overlap routes (in particular continental destinations)*".²⁸ Given the geographic scope of the OFT's investigation, it need not be concerned about Irish-Continental routes.
- (b) The Commission was concerned that a carrier operating only one route to Dublin might face higher unit marketing costs in targeting Irish-origin passengers.²⁹ However, this issue is not a significant barrier to entry on UK-Dublin routes in 2011: (i) some of the airlines identified in section (a) above already operate at least one route into Ireland (e.g., Flybe, Jet2 and Air France-KLM); (ii) a significant proportion of passengers on UK-Ireland routes originate from the UK; (iii) since 2007 the use of price comparison websites and targeted marketing (e.g. through internet search advertising) has increased, reducing the need for an airline with a competitive offering to incur significant costs in generalised advertising; and (iv) marketing targeted at the UK may also reach Irish consumers since some media are consumed in both countries.

²⁵ <http://www.dublinairport.com/gns/about-us/airport-development.aspx>

²⁶ <http://www.dublinairport.com/gns/about-us/statistics.aspx>

²⁷ Case COMP/M.4439, paras 552 et seq.

²⁸ Case COMP/M.4439, para. 568.

²⁹ Case COMP/M.4439, para. 568.

- (c) The European Commission was concerned that the merged Ryanair/Aer Lingus might react aggressively to any new entry.³⁰ The theory of harm that the Commission was investigating was wholly different from the present case. The Commission was considering whether, if Ryanair could control all of Aer Lingus' commercial decisions (pricing, scheduling etc.), this would lead to a significant impediment to effective competition. By contrast, the first and third theories of harm discussed in this paper (namely that Ryanair would soft-pedal against Aer Lingus or that there would be coordinated effects) involve Ryanair competing less hard against Aer Lingus. If this occurred, it would create an obvious opportunity for entry in circumstances where an aggressive response from Ryanair to that new entry would affect Aer Lingus as well as the entrant, undermining Ryanair's (hypothesised) strategy of soft-peddling or any coordinated outcome.³¹ This shows that the European Commission's argument regarding Ryanair's alleged "reputation" does not apply to the present investigation.
- (d) Related to point (c), the Commission concluded in 2007: "*destination based entry ... [was] in general not sufficient to replace the competitive constraint exerted by the Merging Parties on each other pre-merger... Even though entry may occur on particular routes, such selected entry cannot replace the competitive pressure exerted by the two Merging Parties today.*"³² By contrast, in the present case, Ryanair and Aer Lingus remain separate and independent competitors. The theories of harm ask whether the competition between them is less intense than it would be in the absence of Ryanair's minority shareholding. Any reduction in competition that would need to be made up by actual or potential entry is therefore very much smaller than in the case of a full merger where all competition between the merging parties is lost. The "*selected entry*" that the Commission envisaged may occur *would* be sufficient to counterbalance a limited and selected loss of competition on some UK-Ireland routes, even if it were not sufficient to counterbalance the loss of all competition on all overlap routes in the EU.

(c) Lack of Recent Entry is Due to Intense Competition and Falling Demand

- 4.12 In recent years, there has been limited entry/exit activity on the affected routes. This can be explained by two factors.³³ First, the markets are already highly competitive. Ryanair is the largest and most successful low cost/low fares airline in Europe. Ryanair's fares remain consistently low on all its routes due to Ryanair's "yield passive, load factor active" business model. Aer Lingus has also proven to be an aggressive competitor in the market, competing with other airlines on both price and service. Thus, routes served by both Ryanair and Aer Lingus are highly competitive

³⁰ Case COMP/M.4439, para. 569.

³¹ In any event, there are plenty of instances of airlines entering against Ryanair. For example: Jet2 has recently announced its entry on routes from Glasgow to Tenerife, Barcelona, Ibiza, Alicante and Faro, from Edinburgh to Alicante and Malaga, from Manchester to Barcelona and from Leeds Bradford to Gran Canaria; easyJet has announced its entry on routes from Manchester to Madrid, London Gatwick to Fuerteventura, and London Southend to Barcelona; and IAG/Iberian has announced its entry on the Manchester to Madrid route.

³² Case COMP/M.4439, para. 584.

³³ At present, the oil price is high (reducing the incentive for airlines to buy new aircraft and to operate their existing fleets), although it has varied significantly over the period since 2007.

and this level of competition may deter new entrants (as well as evidencing the absence of an SLC).

4.13 Secondly, the economic downturn that began shortly after the EU Commission's 2007 Decision has reduced demand for air travel, thereby diminishing profitable opportunities for potential entrants. A number of elements contribute to these conditions, most notably a failing economy both in Ireland and in the UK and DAA cost increases which Aer Lingus' CEO has described as "insane":

- (a) Ireland was in recession from September 2008 until the first quarter of 2010. It has endured drastic austerity measures and high unemployment figures (currently at 14.3 per cent.). One consequence of this harsh economic climate has been reduced demand for air transport services in some of the affected markets. Between 2007 and 2010, the number of passengers travelling annually through Dublin airport has decreased by around 21 per cent. and the current capacity utilisation is at an historic low of around one-third.³⁴ This fall in demand has been made worse by a burdensome travel tax levied by the Irish government.³⁵
- (b) The UK economy was in recession from January 2009 until January 2010 and fears of a double-dip recession have recently resurfaced. The coalition government has implemented austerity measures and unemployment remains high (currently around 8 per cent.). Since 2008, the number of passengers travelling through UK airports has been falling. According to CAA statistics, between 2008 and 2010, passenger air traffic between the UK and Ireland fell from 12.3 million to 9.5 million passengers, i.e. a drop of around 22 per cent.³⁶

4.14 Against this backdrop, it is hardly surprising that potential competitors have not recently entered or expanded on to the Irish market.

5. **First Theory of Harm: Ryanair is *not* incentivised to compete less strongly against Aer Lingus and has not *in practice* competed less strongly against Aer Lingus since it became a minority shareholder**

(a) Introduction

5.1 Ryanair has retained Oxera to provide economics advice and Oxera has led the preparation of this section. As a result, it is relatively technical in nature.³⁷

³⁴ See para. 4.10(c) above.

³⁵ In its 2009 Budget, the Irish government introduced an air travel tax of €10 per passenger per route on all routes with a distance greater than 300 km. In March 2011, this was reduced to €3 per passenger on all European routes.

³⁶

http://www.caa.co.uk/docs/80/airport_data/2010Annual/Table_11_Intl_Pax_Traffic_to_from_UK_by_Country_2000_2010.pdf

³⁷

Oxera would, of course, be willing to discuss with the OFT's economists the contents of this section and the general availability of data.

- 5.2 The OFT is, of course, increasingly using "Indicative Price Rise" ("IPR") and Gross Upward Pricing Pressure Index ("GUPPI") calculations to provide a better proxy of merger effects. In its decisions, the OFT has commonly ruled out competition concerns in markets in which the model predicts a price increase of less than 5 per cent. Both models have pros and cons. In particular, on the facts of this case, both suffer from the disadvantage that they inevitably predict price increases, with the only issue being the magnitude. Nevertheless, for reasons described in section (b) below, Oxera identified the IPR model as the more appropriate for this case and have tailored it to take account of the fact that Ryanair has only a minority stake. Oxera's work shows that, even if Ryanair had the information about Aer Lingus' route-by-route profitability necessary to set a profit maximising price, nevertheless price rises of 5 per cent. or more are *not* predicted and, accordingly, in line with the OFT's approach, the first theory of harm can be ruled out with confidence. Section (c) explains that, even if the model indicated that Ryanair had an incentive to raise prices by more than 5 per cent., it lacks the knowledge of Aer Lingus' route-by-route profitability necessary to implement the strategy and the ability to capture the increased profits that Aer Lingus earns. This imperfect information means that, in reality, any price increases would be lower than those predicted by the model. Section (d) explains that Ryanair's minority stake has not affected entry and exit decisions. Finally, section (e) describes the intense competition that has been observed since Ryanair acquired its stake, which is inconsistent with a theory that Ryanair is "soft-peddalling" when competing against Aer Lingus.

(b) An IPR Calculation Demonstrates that Ryanair has no Incentive to Raise its Prices Above the OFT's 5 per cent. Threshold

- 5.3 The OFT has increasingly used the IPR metric.³⁸ The IPR and GUPPI indicators originate from US merger control and are intended as first stage screening devices to rule out competition concerns. If adapted properly, the IPR metric might be used as a screening device to assess the impact of Ryanair's minority stake in Aer Lingus on the prices charged by the two firms, albeit that it will tend to overestimate the impact. A key assumption made in the derivation of the original IPR formula is that the two merging parties jointly control the operations of the merged firm, which is therefore able to maximise profits across both firms' operations. This assumption needs to be relaxed in the present context since Ryanair's passive minority stake does not enable it to influence commercial decisions made by Aer Lingus. Moreover, a second change to the original IPR formula has to be made in order to reflect the different ownership structure. If those assumptions are adapted, a modified formula is obtained that relates the IPR to four variables: the ratio of prices charged by the two firms, the variable margin of Aer Lingus and both firms' diversion ratios. The diversion ratios from Ryanair to Aer Lingus and from Aer Lingus to Ryanair are assumed to be equal to each other (this assumption has frequently been made by the OFT).³⁹

³⁸ The simplest version of the IPR formula: $\frac{\Delta p_A}{p_A} = \frac{\Delta p_B}{p_B} = \frac{m d}{2(1-d)}$, where p_A and p_B are the prices charged by the merging parties (A and B) prior to the merger, Δp_A and Δp_B are the price changes (i.e. post-merger prices minus pre-merger prices), m is the pre-merger margin and d the diversion ratio (pre-merger margins and diversion ratios are assumed to be the same for both firms).

³⁹ The modified IPR formula takes the following form: $IPR_R = \frac{2 \cdot 29.8\% \cdot m_A \cdot D}{4 - D^2} \cdot \frac{p_A}{p_R}$, where IPR_R is Ryanair's IPR, p_A and p_R are the (pre-divestment) prices charged by Aer Lingus and Ryanair, respectively, D is the diversion ratio and m_A is Aer Lingus' variable margin.

- 5.4 In order to assess whether the price rise predicted by the adapted IPR formula crosses the commonly used 5 per cent threshold,⁴⁰ estimates of Aer Lingus' variable margins and the ratio of Aer Lingus and Ryanair prices and diversion ratios can be plugged directly into the formula. The IPR obtained in this way can then be compared to the 5 per cent threshold. The formula can also be used in an alternative way as follows. First, one of the variables of the model, e.g. the diversion ratio, is selected. Secondly, the other variables in the model are replaced with point estimates. Thirdly, the value of selected variable for which the IPR is exactly equal to 5 per cent is calculated, given the values of the other variables. This value is called the *critical* value of the selected variable. In order to assess whether or not the 5 per cent threshold is met, one has to analyse whether the critical value is likely to be smaller or larger than the actual market value of the selected variable. If, for example, the critical value of the diversion ratio is larger than the largest diversion ratios observed across a variety of markets, one can conclude that the 5 per cent threshold is never met. It is important to note that the critical value can only be calculated for one variable at a time; the remaining variables in the IPR formula need to be replaced with reasonable estimates. If, for example, the critical value for the diversion ratio is calculated, the price ratio and Aer Lingus' variable margin have to be estimated from market data.
- 5.5 The advantage of this approach is that it generally enables robust conclusions in the absence of an exact estimate of one of the variables (although estimates for all other variables need to be available). However, this approach may not always be successful. If it cannot be argued that the critical value is always larger (or always smaller) than any plausible value observed across different markets, it is not possible to draw conclusions using this approach. In this case, another approach has to be applied.
- 5.6 Since diversion ratios are particularly difficult to estimate, the above approach can be used to determine whether or not the 5 per cent threshold is met in the absence of immediately available data on diversion ratios. Although no precise estimate of diversion ratios is needed in order to implement the approach, a range of plausible diversion ratios needs to be determined. The survey-based evidence cited in Annex 2.6 of the 2007 Decision suggests a range of between 18 per cent. and 54 per cent.⁴¹ In order to show that the 5 per cent threshold is met, it needs to be demonstrated that the critical diversion ratio is larger than the 54 per cent. However, the evidence is likely to overestimate the true diversion ratio because the survey question asked consumers whether they would "consider switching" to the other airline – and not whether they would actually switch and under what conditions. For routes where both airlines operate from different airports, the 2007 Decision cites a lower estimated diversion ratio of 36 per cent. and on London routes, this estimate is 34 per cent. Moreover, the 54 per cent. estimate is determined for airport pair routes on which only Aer Lingus and Ryanair operate. On routes with more than those two competitors, diversion ratios are considerably lower (e.g., 33 per cent. on the Dublin-Frankfurt route which is also operated by Lufthansa). The choice of a threshold of 54 per cent. can therefore be considered as highly conservative. In addition we choose

⁴⁰ See *Asda / Netto*, para. 36.

⁴¹ According to the survey evidence cited in Annex 2.1 of the 2007 Decision, 90.6 per cent. of Ryanair customers and 66.1 per cent. of Aer Lingus customers would have bought a cheaper ticket from another airline. Clearly, those numbers do not satisfy the OFT's definition of diversion ratios between Aer Lingus and Ryanair as they include customers switching to a third party.

conservative estimates of Aer Lingus' variable margins and the ratio of Aer Lingus and Ryanair prices. Oxera allow Aer Lingus' prices to be around [CONFIDENTIAL] higher than Ryanair's price level, reflecting a price sampling exercise and consistently with Aer Lingus' higher cost base (a greater disparity in prices would lead to a lower critical diversion ratio). In addition, we conducted a basic estimation of Aer Lingus' variable margin. The result of this analysis implies that a margin in the range between 20 per cent. to 30 per cent. can be considered as conservative.⁴² Combining those assumptions, we find a critical diversion ratio between [CONFIDENTIAL]; other specifications produce a critical diversion ratio of [CONFIDENTIAL].⁴³ This range clearly lies above the range of plausible diversion ratios identified above (i.e. above the 54 per cent. threshold). It follows that, despite the conservative nature of this analysis, the 5 per cent threshold is clearly not crossed. The OFT should therefore rule out the first theory of harm.

- 5.7 Since the critical diversion ratio lies clearly outside the interval of all plausible diversion ratios, the approach adopted above is sufficient to conclude that the OFT's 5 per cent threshold is not crossed. In other words, even if one were to estimate the diversion ratio from market data, any plausible outcome of this procedure would imply that the 5 per cent threshold is not crossed. Oxera therefore do not consider it relevant to obtain diversion ratios from a costly consumer survey.
- 5.8 Oxera's conclusions are based on a simple and conservative estimate of Aer Lingus' margin. If the OFT were to estimate Aer Lingus' margin, it can reject Oxera's conclusions only if the value found in its study is considerably larger than the 30 per cent. Oxera assumed here. If such a large margin is found, Oxera's conclusions are still likely to remain valid, owing to the conservative nature of the analysis (whose results are not, in any case, very sensitive to the Aer Lingus margin). And in this case, the diversion ratios would still have to be estimated from a consumer survey in order to determine the actual IPR.
- 5.9 As noted in section (a) above, a simpler Gross Upward Pricing Pressure Index ("GUPPI") is sometimes used as an alternative to the IPR metric in order to assess the likely effect of a merger. The GUPPI approach compares the upward pressure on post-merger prices in the absence of efficiency savings to the magnitude of efficiency savings that arise from the merger. If ownership is only partial (as in the case of Ryanair's minority stake in Aer Lingus), a modified GUPPI formula⁴⁴ can be used that accounts for the reduced upward pricing pressure as a result of partial ownership.

⁴² We find that Aer Lingus' variable margin is below 10 per cent.. The analysis uses the following cost categories (obtained from the presentation "Aer Lingus - Investor and Analyst Day" in London on 26/01/2010): staff, aircraft lease, maintenance, distribution, ground operations, catering and other, airport charges, enroute charges, fuel. We understand that those cost categories may not perfectly reflect Aer Lingus' variable costs. We address this issue by allowing the margins used in our analysis to be 2 to 3 times larger than the margins obtained here.

⁴³ [CONFIDENTIAL]

⁴⁴ The modified GUPPI approach compares the following two expressions: $\theta \frac{(P_2^0 - c_2^0)d_{12}}{P_1^0} > \frac{c_1^0 - c_1}{P_1^0}$, where d_{12} is the diversion ratio from firm 1 (Ryanair in this case) to firm 2 (Aer Lingus in this case), θ is the size of the minority stake, c_1^0 , P_1^0 and P_2^0 indicate marginal costs and prices obtained in the absence of the minority stake, and c_1 is marginal cost obtained in the presence of the minority stake (ie the efficiency savings of firm 1 are given by $c_1^0 - c_1$ and firm 2's gross profit margin is given by $P_2^0 - c_2^0$).

5.10 As the OFT will know, the GUPPI approach is not designed to derive specific estimates of price effects but rather to enable a comparison between the magnitudes of upward and downward pressures on market prices. There is no downward pressure in the present case since Ryanair's minority stake in Aer Lingus does not produce any efficiency savings (the two firms' operations remain separate). If efficiency savings are zero, the modified GUPPI approach always predicts, by definition, net upward pricing pressure. However, in reality, there are countless examples of firms holding minority stakes that would not be considered harming competition. For example, nobody would claim that competition between Airbus and Boeing would be diminished if Airbus were to purchase 1,000 shares in Boeing. The (modified) IPR metric, on the other hand, explicitly quantifies the price effect of Ryanair's minority stake (in the absence of efficiency savings). Such an approach has some advantages over the GUPPI approach in the present context because it puts less weight on efficiency savings (which are irrelevant) and more weight on measuring (theoretical) price increases.

(c) Ryanair has neither the ability nor the incentive to sacrifice its own profits to favour Aer Lingus

5.11 Even if the modified IPR model were to predict a price rise of more than 5 per cent, this is not a realistic proxy. Ryanair lacks access to the information necessary in order profitably to implement a strategy of raising prices. The first theory of harm assumes that Ryanair knows Aer Lingus' profit margin on the route in question (which is required to calculate optimal prices). This assumption is highly unrealistic. Although Aer Lingus' overall profit margin is publicly available, Ryanair would need to know Aer Lingus' profit margin for individual routes in order to determine its optimal price rise. This information is not available to Ryanair, which makes it very difficult to raise prices by the correct amount. In fact, if Ryanair raises its prices by too much it risks losing money. Ryanair therefore lacks the *ability* profitably to charge higher prices.

5.12 The first theory of harm is based on the assumption that Ryanair earns profits from its minority stake if it raises its prices (because the price rise has a positive impact on Aer Lingus' profits due to customers switching from Ryanair to Aer Lingus). In reality, however, it is unlikely that Ryanair can capture those profits. Since Ryanair does not have any control over Aer Lingus it cannot control its dividend policy.⁴⁵ Instead of converting additional profits obtained from higher prices into dividends, Aer Lingus may decide to use this money for alternative purposes, possibly harming Ryanair. Acting in the general interest of its shareholders, it may use additional profits to compete more aggressively with Ryanair. For example, Aer Lingus may use those profits to improve its lounges or amenities to attract passengers away from Ryanair. Since Ryanair does not have any control over Aer Lingus' operations, it cannot prevent such investments. It is therefore extremely unlikely that Ryanair would have the *incentive* to raise its prices.

⁴⁵ Ryanair recently tried to convince Aer Lingus to pay a dividend to shareholders and was rebuffed.

- 5.13 Finally, any incentive Ryanair may have to "soft-pedal" against Aer Lingus is reduced because such soft-peddalling would or might lead to entry or expansion by rivals for the reasons given in section 4 above.

(d) Ryanair's Minority Stake has not affected Entry and Exit Decisions

- 5.14 We have also investigated a variation of the first theory of harm involving possible effects of Ryanair's minority stake on entry and exit by Ryanair. The theory of harm is that Ryanair might avoid head-to-head competition against Aer Lingus on routes operated by Aer Lingus in order to maximise the value of its minority shareholding in Aer Lingus..
- 5.15 In this section we examine instances of entry and exit by Ryanair before and after the "event" of Ryanair acquiring its minority stake, which demonstrates that the theory of harm discussed in para. 5.14 above is invalid. The intensity of competition between Ryanair and Aer Lingus since the "event" is also demonstrated by the evidence summarised in section (e) below.
- 5.16 In order to have a relevant set of entry/exit events, we have focused on UK-Ireland routes. A qualitative analysis is the only practical approach since there is no measure available of *ex ante* expectations of the profitability of a particular entry decision, and moreover the factors influencing entry/exit decisions for Ryanair are [CONFIDENTIAL].
- 5.17 We have examined the reasons for Ryanair's entry and exit decisions before and after the "event" of acquiring the minority stake: see [Annex Removed]. This review supports the conclusion that the minority stake has had no effect on these decisions. Looking first at the entry decisions where no possible overlap with Aer Lingus existed, the main reason for all entry decisions was [CONFIDENTIAL]. The same is true for entry decisions where potential or actual overlaps exist, [CONFIDENTIAL]. The minority stake in Aer Lingus had no influence on any of these decisions.
- 5.18 Looking at exit decisions, most Ryanair exits were prompted by [CONFIDENTIAL]. The remaining exit decisions were made either [CONFIDENTIAL]. The minority stake in Aer Lingus had no influence on any of these decisions, and there is no discernable difference according to whether the route had any possible overlap with Aer Lingus.

(e) There is no evidence from the last five years that Ryanair has competed less strongly against Aer Lingus

- 5.19 The first theory of harm is also disproved by the intense competition that has occurred between the two companies over the five years since Ryanair first acquired its minority stake, as evidenced by the following:
- (a) The study of entry and exit summarised in section (d) above.
 - (b) [CONFIDENTIAL].

- (c) A review of the press releases annexed to the MI paper, which paint a picture of Ryanair relentlessly targeting Aer Lingus on the basis of its lower prices and larger network.⁴⁶
 - (d) A review of Ryanair's print advertising, which includes many examples of adverts that target Aer Lingus specifically: [Annex Removed].
 - (e) The history of dealings between the parties, which is summarised in section 4.2 of the MI Paper, and is wholly inconsistent with any suggestion that Ryanair has sought – whether unilaterally or through some form of coordination – to compete less aggressively against Aer Lingus.
- 5.20 There is also scope for further increased competition in future: Ryanair has offered the Dublin Airport Authority ("DAA") and Irish Government growth of 5 million passengers at Irish airports (even though, if accepted, this would clearly reduce the value of its shareholding in Aer Lingus).
- 5.21 Finally, Aer Lingus' share price has fallen from a peak of €3.275 per share during the first six months of trading to under €0.60 in 2011, which is consistent with it facing strong competitive constraints.

6. Second Theory of Harm: if Ryanair holds material influence through its ability to block a special resolution and a scheme of arrangement, this does not give rise to a realistic prospect of an SLC

(a) Introduction

- 6.1 Ryanair believes that it does not have material influence over Aer Lingus for the reasons given in the "Submission to the OFT on Material Influence" ("**the MI Paper**"). As noted in section 1 above, this paper has been prepared without prejudice to that primary case and on the assumption that, notwithstanding Ryanair's arguments, the OFT finds that Ryanair may have material influence over Aer Lingus.
- 6.2 Ryanair has held its stake in Aer Lingus for five years. This section reviews the history of matters taken to a shareholder vote during that period and explains that the vast majority of such resolutions could have had no conceivable impact on Aer Lingus' commercial strategy and [CONFIDENTIAL]. There is accordingly no evidence that Ryanair's stake may have resulted in an SLC and there are no grounds for believing that this might change in the future. We then explain why the issues discussed in *BskyB / ITV* do not arise here (section (c)).⁴⁷

⁴⁶ Many of the press releases seek to highlight to consumers Ryanair's status as the lowest fares airline with an extensive network, e.g. those calling for lower fares or the abolition or reduction of Aer Lingus' fuel surcharges. See also the press releases of 2 February 2010 (Ryanair opened seven new Summer routes from Cork to compete with Aer Lingus' high fares from Cork), 28 July 2010 (Ryanair open three new Winter sun routes from Cork at much lower fares than Aer Lingus) and 30 July 2010 (Ryanair launched a €0 one way rescue fare for Aer Lingus passengers stranded by cabin crew strikes).

⁴⁸ For example, Aer Lingus has entered partnerships and alliances with other airlines without putting them to a shareholder vote, including a franchise agreement with Aer Arann that is described in [Annex Removed].

(b) An Analysis of Matters Put to Shareholder Votes

- 6.3 The second theory of harm is that Ryanair could weaken the competitive constraint it faces from Aer Lingus by using its position as a shareholder to worsen Aer Lingus' competitive offering, for example in terms of an attempt to force Aer Lingus to differentiate its offering from that of Ryanair, or else constrain Aer Lingus' expansion on Ryanair routes.
- 6.4 Ryanair would be able to do this only if: first, there were relevant decisions that required a shareholder majority vote (e.g., decisions to open new services, or to change the product positioning of Aer Lingus); and, secondly, Ryanair could block these decisions using its voting rights.
- 6.5 However, the history of voting records at Aer Lingus general meetings over the last five years, which is set out in detail in the MI Paper, clearly shows that:
- (a) Aer Lingus' decisions to open new routes overlapping with Ryanair or change its competitive stance in the market (or any similar decisions) have *never* been the subject of a shareholder vote, but rather are always within the control of Aer Lingus management without specific shareholder approvals;⁴⁸ and
 - (b) on the very rare occasion Aer Lingus has put to shareholder vote a matter that might be considered to affect opening new services (specifically, the 10 April 2008 EGM voting on the Airbus purchase arrangement) the motion has carried easily despite Ryanair's opposition.
- 6.6 Ryanair's conduct has in fact been *opposite* to that which would be expected if Ryanair were attempting to weaken the competitive constraint it faces from Aer Lingus.
- (a) As explained in the MI paper in section 4.2(a), in September 2007, Ryanair attempted to call an EGM of Aer Lingus so that shareholders could vote on a decision taken by the Aer Lingus Board to close its Shannon-Heathrow route in favour of opening a base in Belfast. Aer Lingus rejected Ryanair's call for an EGM and proceeded to close the Shannon-Heathrow route as planned. As it happens, Ryanair operated a Shannon-Stansted route, which if Aer Lingus' Shannon-Heathrow route had closed might have been a possible beneficiary from the Aer Lingus Board's decision. Also Ryanair did not operate routes from Belfast, meaning that it was very unlikely to have lost out from the Aer Lingus Board's intention to operate from Belfast. Ryanair's conduct in September 2007, opposing the Heathrow closure, therefore seems completely opposed to the theory of harm that Ryanair has sought, or will seek, to use voting rights to constrain Aer Lingus' expansion on Ryanair routes.
 - (b) Ryanair has offered the DAA and Irish Government growth of 5 million passengers at Irish airports (even though, if accepted, this would clearly reduce the value of its shareholding in Aer Lingus).

⁴⁸ For example, Aer Lingus has entered partnerships and alliances with other airlines without putting them to a shareholder vote, including a franchise agreement with Aer Arann that is described in [Annex Removed].

- 6.7 There is accordingly no evidence that Ryanair's stake may have resulted in an SLC and there are no grounds for believing that this might change in the future.

(c) The Issues Discussed in BSKyB/ITV do not Arise Here

- 6.8 In BSKyB / ITV the Competition Commission found:

*"it likely that the board would need to make major investments requiring external funding over the next two or three years. A non-pre-emptive rights issue would be the only feasible or efficient funding mechanism for some investments. BSKyB's ability to block a special resolution would limit ITV's ability to raise funds, ruling out some strategic options and affecting its ability to compete in the market for all-TV."*⁴⁹

BSkyB might *"disrupt an acquisition of ITV that might otherwise strengthen ITV's competitive position, or encourage the acquisition of ITV by another buyer who might act in BSKyB's interests."*⁵⁰

- 6.9 By contrast, in the present case, Ryanair has held its stake for five years. During this period, Aer Lingus has never sought a waiver of pre-emption rights for the purposes of implementing its commercial strategy⁵¹ and no party has made an offer to acquire Ryanair's stake or made a stock exchange announcement identifying an interest in bidding for Aer Lingus. Is it therefore not the case that the acquisition of the minority stake may *have resulted* in an SLC.

- 6.10 Turning to the prospective analysis, it is *very unlikely* that Aer Lingus will *need* a waiver of pre-emption rights as *the only feasible or efficient mechanism* in order to implement its strategic options. As discussed in section 3.4 of the MI Paper:

- (a) Aer Lingus has very large cash reserves – it has gross cash of €25m – and access to other means of raising capital including aircraft leases and bank lending.
- (b) In line with guidance from the Irish Association of Investment Managers, Aer Lingus' requests for a waiver of pre-emption rights have all been limited to issuing 5 per cent. of the currently issued equity share capital. This would enable it to raise at most €5.49m,⁵² a trivial sum compared to its gross cash of €25m.
- (c) Aer Lingus' strategy – which it has announced to investors – is to downsize, whilst forming alliances with other airlines, and it is therefore very unlikely to wish to make a large strategic acquisition or other significant investment.

⁴⁹ Summary, para. 17.

⁵⁰ Summary, para. 18(c).

⁵¹ Aer Lingus has sought such waivers of pre-emption rights as a matter of routine and Ryanair has blocked them for the reasons described in the MI Paper.

⁵² 534m shares in issue x €0.58 current share price x 0.05 = €5.49m. Any equity capital raising is likely to be at a discount to the then prevailing share price, which would reduce the sum raised.

- 6.11 Further, in the light of the successful turnaround by Aer Lingus' current management, it is also *very unlikely* that Aer Lingus would *need* to agree to a takeover to *strengthen its commercial position* or facilitate its commercial strategy.⁵³ Aer Lingus is well capitalised and able to implement its commercial strategy without needing a takeover. Moreover, it is also important to note that Ryanair has made clear that it is open to offers for its stake.⁵⁴
- 6.12 These remote possibilities are insufficient to give rise to a *realistic prospect* of a *substantial* lessening of competition.

7. Coordinated effects

(a) Introduction

- 7.1 There is not any meaningful prospect of coordinated effects being created or enhanced by Ryanair's minority share ownership in Aer Lingus.
- 7.2 The conditions for there to be coordinated effects in a merger situation are set out in section 5.5 of the Guidelines.
- (a) Firms need to be able to reach and monitor the terms of coordination.
 - (b) Firms have to find it in their individual interests to adhere to the coordinated outcome.
 - (c) There must be little likelihood of coordination being undermined by competition from outside the coordinating group.
- 7.3 In a normal case, the first question is whether there is any evidence of pre-merger coordination. However, in this case, Ryanair has held its stake for five years and so the first question is instead whether there is any evidence of actual coordination following the acquisition of its stake. If there is not, then coordinated effects can be dismissed as a theory of harm, unless there were evidence of a recent or expected change of circumstances that might result in the emergence of coordination. In this case, the evidence indicates that the acquisition by Ryanair of its stake has not resulted in any dampening of competition: see section 5(e) above. There are no recent or expected changes of circumstances that might alter this analysis and coordinated effects can therefore be dismissed as a concern.

⁵³ Moreover, whilst there is regular chatter about the possibility of a bid for Aer Lingus by a national flag carrier such as International Airline Group (which incorporates British Airways), Air France/KLM or Lufthansa, and most companies become attractive if the price is low enough, any potential bidder would be concerned about Aer Lingus' heavily focus on Ireland, which is very weak economically and offers no prospects of growth in the medium term.

⁵⁴ See http://www.nytimes.com/2011/05/28/business/global/28air.html?pagewanted=2&_r=2

- 7.4 For completeness, in the remainder of this section Ryanair explains why none of the three conditions for coordinated effects are present⁵⁵ (sections (b) to (d)) and why this conclusion remains true regardless of Ryanair's minority stake in Aer Lingus (section (e)). In a standard merger two firms are integrated and, following the merger, operate as a single entity maximising joint profits. Thus, the issue under consideration is the manner in which the merger affects the incentives of the merged firm, and its rivals in the market, to engage in coordinated behaviour. In this case, however, Aer Lingus and Ryanair do not operate as a single entity maximizing joint profits, and the primary issue to be considered is the manner in which Ryanair's shareholding in Aer Lingus changes the incentives of the two companies to coordinate their behaviour with one another.
- 7.5 Before turning to the analysis, Ryanair makes two preliminary comments about the scope of the analysis.
- (a) We focus our discussion on possible coordination on price, but also address in section (f) possible coordination on non-price elements, including market shares.
 - (b) Any theory of coordinated effects would need to identify the candidate coordinating group. As discussed further below, if the group is limited to Ryanair and Aer Lingus, then the competitive fringe is larger. By contrast, if the group comprises Ryanair, Aer Lingus, bmi and Air France then there are six potential relationships, only one of which is affected by the cross-shareholding, implying that the cross-shareholding is very unlikely to be material to the analysis of coordinated effects. We discuss both candidate coordinating groups in this section.

(b) Condition 1: Reaching and monitoring coordination

- 7.6 The first condition for coordinated effects is that the firms have to be able to reach a coordinated understanding, and then to monitor that other firms are adhering to that understanding.
- 7.7 Ryanair does not believe that it would be possible for airlines in the UK to Ireland aviation markets to reach an initial coordinated understanding or, in any practicable way, to monitor adherence to that coordinated understanding.
- 7.8 There are several reasons why reaching a coordinated understanding in the aviation market would be extremely difficult.
- 7.9 *Significant cost asymmetries.* In order to coordinate, all firms must reach a combined understanding of a price that is above the competitive level and which all are happy to continue to adhere to. The greater the cost asymmetries between firms, the more difficult it will be to find a price that all are willing to adhere to, as a firm with a higher level of marginal costs will desire a higher price than a firm with lower marginal costs. In the current case, Ryanair believes that it has a marginal cost base

⁵⁵ See also *easyJet / GB Airways*, paras 50 to 53, ruling out coordinated effects concerns in an airline merger.

well below that of Aer Lingus, Air France, or bmi. In such a case, Ryanair would have little incentive to coordinate its price with other airlines, as it will be able to price profitably at levels which would be loss-making for its competitors.

- 7.10 *Significant differences in service offerings.* The differences in service offerings between Ryanair and its rivals add another layer of complexity when attempting to determine a tacitly collusive price. Some services which are effectively bundled into the ticket price of competitors (e.g., checking in hold baggage, checking in at the airport, allocated seating) are separate charges for Ryanair passengers. Even if Ryanair had the same cost base as other airlines (which it does not), it would therefore need to set a lower ticket price than its rivals to reflect these disaggregated charges. However, this would complicate "agreeing" the coordinated price, as not all passengers use any of these disaggregated charges – there would therefore be considerable scope for confusion between Ryanair and any other airline trying to tacitly collude, as there would be a need for the coordinated prices to be different.
- 7.11 *Lack of well-defined focal price points.* Often, coordination can be focussed around certain well-known price points, with moves away from these price points requiring large proportionate price changes.⁵⁶ The airline sector does not have any such obvious price points, and it is therefore unclear what the price point for any initial coordination would be. Pricing is often undertaken in small increments; at the same time, passengers on the same flight may have paid for their flight in different currencies (for example, in pounds sterling and euros), adding an extra degree of complexity, with different home country prices having been quoted at the time of purchase, and different airport tax and airport charge levels on each airport pair.
- 7.12 Overall, therefore, there appear to be substantial impediments to Ryanair and its competitors ever reaching an initial coordinated position. Ryanair believes that due to its low cost base it will always be able profitably to undercut all of its competitors in the market. As such, Ryanair has no incentives to enter into coordination with rivals.
- 7.13 In order for coordination to be sustainable over time, two features must be present. First, there must not be frequent changes in the coordinated price desired by firms which are coordinating; and, secondly, firms must be able to monitor whether coordination is being observed. Neither of these is the case given the conditions of competition in aviation markets in which Ryanair is active.
- 7.14 *Different extent of cost shocks.* Even if an initial understanding can be reached, then there will be a need to sustain that coordination in the face of shocks to demand and supply. On the supply side, the very different set of services offered by Ryanair in its ticket price, combined with its lower cost base, means that its average cost per passenger would change in a different way to its rivals when faced with cost shocks. In the aviation sector, these are most commonly shocks in the price of oil, causing increases or decreases in fuel costs, but can also be shocks from changes in the taxation regime facing airlines, or in labour costs given the strikes which have regularly afflicted airlines such as Aer Lingus. In particular, airlines have different fuel hedging strategies⁵⁷ which will have the impact of creating asymmetric cost

⁵⁶ For example, in many retail sectors where £9.99 might be considered a key price point.
⁵⁷ Ryanair and Aer Lingus have pursued different fuel hedging strategies.

impacts even when airlines have similar underlying cost structures. Where there are asymmetric cost shocks, this will tend to undermine coordination, as one airline will wish to change the coordinated price by a different amount than the other airline.

- 7.15 Different extent of demand shocks. Ryanair's low cost business model, with its relentless focus on cost minimisation at the expense of any optional "frills" places it in a different segment of the market than Aer Lingus' higher cost model, and the full-fare offerings of bmi's services from Heathrow, and Air France's services from City. This will tend to create asymmetries in the extent of demand shocks which affect the airlines. For example, Aer Lingus' route between Heathrow and Dublin is likely to have a higher proportion of business travellers than Ryanair's flight between Stansted and Dublin. Consequently, if there is a decline in business traffic, but not leisure traffic, then this will reduce Aer Lingus' demand by more than Ryanair, and Aer Lingus will therefore want to reduce the coordinated price by more than Ryanair. This form of asymmetric shock will therefore tend to undermine coordination.
- 7.16 Frequency of cost and demand shocks. Cost and demand shocks, particularly if significant, will change the coordinated price that firms wish to charge. Where there are frequent shocks, therefore, firms will have difficulty sustaining coordination, as there will be a need for firms continually to reach a new agreement on the coordinated price. The airline industry is one which is particularly prone to cost shocks (often from oil price changes, but also from security procedure changes) and demand shocks (with sharp drops in demand having previously been observed after the September 11th attacks and during the second Gulf War). These shocks will make it difficult to sustain coordination over time.
- 7.17 Difficulties in monitoring defection from coordination. [CONFIDENTIAL]. Aer Lingus is also believed to operate a yield management system, but one which targets load factors less intensively. In the presence of such complex yield management systems, which are simultaneously operating across a large number of routes, and with separate prices for each individual flight, it is nearly impossible to monitor whether there has been a breach of a coordinated pricing policy. To do so would require continuously observing prices across many thousands of flights, potentially in multiple currencies at the same time. [CONFIDENTIAL]. Consequently, it would be impossible either for an airline other than Ryanair to determine the yield which Ryanair obtains on a given route, or for Ryanair to ascertain other airlines' yields. The monitoring condition is therefore clearly not met.
- 7.18 Difficulties in determining what constitutes a defection from coordination. In the presence of thousands of prices simultaneously available to passengers, it is likely to be impossible to determine what constitutes a defection from coordination. For example, would pricing a single flight at an inappropriately low level constitute a defection from coordination? It seems unlikely that an airline would enter into a punishment phase for such a limited defection which may impact less than 0.01 per cent. of either Ryanair or Aer Lingus' annual revenue, but if a single incident of breaching the collusive agreement is insufficient to lead to punishment, then there is no obvious point at which an airline's behaviour would be "sufficiently uncoordinated" to lead to punishment. In the absence of such a clear dividing line, then coordination is unlikely to be sustainable.

- 7.19 Presence of alternative outlets for competition. Most models of coordinated behaviour focus exclusively on companies' pricing, which will often be appropriate in industrial markets with broadly homogenous outputs and professional buyers. However, the aviation market is one where customer demand can be substantially influenced by the extent of advertising and quality of service factors (particularly, in Ryanair's experience, timeliness of take-offs and landings). Such non-price conditions of competition can undermine coordination. For example, if Ryanair were to launch a high profile, targeted advertising campaign on a given route, this could have a similar effect on switching demand to engaging in price cuts. Such a campaign could be seen as representing a defection from a coordinated position by an alternative airline which had lost demand due to the advertising campaign, and undermine coordination. There may therefore be a need also to reach an understanding on the level and type of advertising in the market if coordination is to be sustained, further complicating any attempts to coordinate over extended time periods.
- 7.20 It is worth noting that Ryanair has consistently sought to target Aer Lingus with advertising which has aimed to poach passengers from Aer Lingus (examples are attached as [Annex Removed]); and there has been sustained litigation and other disputes between the two companies⁵⁸ as noted in section 4.2 of the MI Paper. Such behaviour, which has been ongoing rather than intermittent, is inconsistent with the "quiet life" which would be expected in sustained coordinated equilibrium. Such non-price forms of competition would tend to undermine price coordination, and therefore represent *prima facie* evidence that there has been no such coordination.
- 7.21 Overall, therefore, there are strong reasons to believe that coordination could not be sustained in the airline markets in which Ryanair operates. There is a significant number of factors tending to undermine both the establishment and maintenance of coordination, and no strong factors tending to support coordination.

(c) Condition 2: Firms must be incentivised to coordinate

- 7.22 It is a core element of Ryanair's corporate philosophy to be the lowest cost airline on all routes on which Ryanair operates. As such, Ryanair believes that it has no incentives to coordinate its behaviour with Aer Lingus, bmi, or any other airline.
- 7.23 Moreover, as set out above, Ryanair has a considerably lower cost base than other airlines. As such, Ryanair will always engage in price competition to the benefit of consumers, as it knows that it will be profitable at price levels which other airlines find unsustainable. Ryanair therefore will always wish to set a lower price than its rivals, removing its incentive to coordinate. Any price which Aer Lingus or another high-cost airline wished to set as a "coordinated" price (which must be a price above the level that the other airline would set in the absence of coordination) would almost certainly be above a level that Ryanair would find commercially attractive. Ryanair's low cost base will reduce or eliminate the additional profits that coordination would in many other markets be expected to generate.
- 7.24 Ryanair also believes that other airlines would not be able to find an effective punishment mechanism against it. As the lowest cost operator in the European airline

⁵⁸ See in particular the Hanger 6 controversy that is discussed in the MI Paper in section 4.2(f).

sector, Ryanair believes that punishments are likely to be very costly for Aer Lingus or any other airline which might attempt to "discipline" Ryanair, while having a much more limited impact on Ryanair's profits. This is particularly the case in the light of Aer Lingus only overlapping on a small (less than 10 per cent.) minority of Ryanair's European routes; any Aer Lingus punishment strategy would be unable to impact on Ryanair's much wider non-Irish operations.

(d) Condition 3: Coordination must not be undermined

- 7.25 Ryanair believes that entry barriers into the markets in which it operates are low, due to low sunk costs arising from the redeployability of assets between different geographically diverse airline markets.
- 7.26 The arguments regarding low barriers to entry are set out in detail in section 4 above, and are not repeated here.
- 7.27 Overall, however, Ryanair believes that even if conditions 1 and 2 were met in the airline markets in which Ryanair operates (which they are not) then any possible coordination between Ryanair and its competitors would be undermined by entry into the market following price increases.

(e) The cross-shareholding does not have any effect

- 7.28 The shareholding between Ryanair and Aer Lingus does not have any effect on the above conclusions regarding coordinated effects. There are two main reasons for this, relating to the two main theories of harm which have been advanced with regard to minority shareholdings in relation to coordinated effects.
- 7.29 *Information exchange.* Both parties ensure that they comply with stock exchange and competition rules regarding price sensitive and commercially sensitive information. As a result, Ryanair receives no information at a detailed enough level to enable coordination to take place at the level of individual routes. As such, the cross-shareholding does not impact on the transparency of Aer Lingus' operations to Ryanair.
- 7.30 *Incentives to coordinate.* Although intuitively a cross-shareholding may enhance incentives to coordinate, on the basis of economic theory the impact can be either to raise or lower incentives for coordination, depending upon the precise circumstances of the case.
- 7.31 On the one hand, at least in an abstract setting, the cross-shareholding raises the incentives for the firm holding the shares to coordinate (in this instance, Ryanair). This is because Ryanair would benefit not only from its own increase in profits, but also to some extent from Aer Lingus' increased profits. On the other hand, the cross-shareholding would increase the costs of engaging in punishment to sustain a coordinated situation (as Ryanair would take a share of any Aer Lingus losses), and therefore would make Ryanair less willing to engage in such a punishment strategy. If Ryanair is less willing to punish Aer Lingus for breaching any collusive equilibrium, then such a collusive equilibrium will be less sustainable, as Aer Lingus will find it more profitable to engage in price cuts. In the sense set out in the Guidelines, the

"extent to which punishing the deviating firm is costly to other coordinating firms" (in this case Ryanair) would be increased.⁵⁹

- 7.32 Moreover, Ryanair's shareholding in Aer Lingus is asymmetric. This means that Aer Lingus has no increased incentives to engage in coordinated behaviour with Ryanair as a result of the shareholding, as it will not consider Ryanair's profits when making its pricing choices. It is generally acknowledged that asymmetries between firms tend to undermine coordination.⁶⁰ Ryanair's shareholding in Aer Lingus, which is not reciprocated, will tend to make the two airlines more asymmetric than otherwise, so helping to undermine the prospects for coordination.
- 7.33 Finally, the practical implication of Ryanair's stake in Aer Lingus has been to create ongoing antagonism between the two airlines as illustrated by several examples provided in Section 4.2 of the MI Paper. Such a hostile atmosphere does not promote coordinated behaviour.
- 7.34 Overall, therefore, the net impact of the asymmetric cross-shareholding would, in Ryanair's assessment of the economic theory, tend to reduce the possibility of reaching and sustaining a coordinated equilibrium.

(f) Non-price collusion

- 7.35 The market characteristics that tend to lead to collusion on non-price factors are similar to those which lead to collusion on prices — there is still a need to reach a coordinated understanding, to monitor that understanding and punish any defections from it, and for coordination not to be undermined by entry to the market.
- 7.36 The one difference from the analysis presented above is that it is likely to be somewhat easier to monitor some non-price aspects of competition (such as scheduling) than it is to monitor price competition. However, given the extent of asymmetries between Ryanair and other airlines (particularly with regard to their relative cost bases), the inability of other airlines to effectively punish Ryanair, and the likelihood of entry if Ryanair does not continue to maintain a competitive offering, Ryanair believes that there is no realistic prospect of coordination.
- 7.37 Moreover, considering non-price factors, Ryanair has had a clear strategy which is not based on coordination with other airlines. Ryanair has relentlessly focussed on making cost savings and ensuring as low a price as possible for its core product, moving many costly ancillary activities into being charged for separately. This has generally led to Ryanair being increasingly differentiated from its rivals. The same non-price strategy has been pursued across the whole of Ryanair's network.
- 7.38 Ryanair and Aer Lingus have never engaged in a policy of geographic market sharing.⁶¹ Moreover, given the features of the market outlined above, Ryanair would have no incentives to coordinate in this way – where there is a profitable opportunity, then Ryanair will pursue that opportunity. It does so irrespective of what other airlines are already operating on the route. Ryanair does not believe that Aer Lingus would be

⁵⁹ The Guidelines, para. 5.5.16, second bullet.

⁶⁰ The Guidelines, para. 5.5.16, final bullet.

⁶¹ See section 5(d) above.

able to find any effective punishment strategy which might act as a deterrent to engaging in head-to-head competition on any profitable Aer Lingus routes.

- 7.39 As such, the conclusions set out above with regard to price coordination continue to hold. Ryanair has not engaged in non-price coordinated behaviour, and there is no theoretic support for the proposition that it might at any point seek to do so.

(g) Conclusions

- 7.40 Overall, therefore, it is clear that there could not be any coordinated effects arising as a result of Ryanair's minority stake in Aer Lingus. None of the three conditions for coordination are met; and, in any case, the cross-shareholding is more likely to reduce the prospect of coordination than to enhance it. There is no prospect of a lessening of competition due to tacit collusion between Ryanair and Aer Lingus, or indeed between Ryanair and any other airline.

8. Conclusion

- 8.1 If the economists on the OFT's team would find it useful to meet with Ryanair's economic advisers (Oxera) to discuss the economic work in this paper and the general availability of data, we would be happy to arrange this.

31 August 2011

LIST OF ANNEXES

[Annexes Removed]