

NON-CONFIDENTIAL VERSION

**COMPLETED ACQUISITION BY
RYANAIR HOLDINGS PLC
OF A MINORITY INTEREST IN
AER LINGUS PLC**

COMPETITION COMMISSION

INITIAL SUBMISSION

**BY
AER LINGUS**

10 July 2012

C A D W A L A D E R

TABLE OF CONTENTS

1.	SUMMARY AND OVERVIEW	3
2.	BACKGROUND ON AER LINGUS	7
3.	HISTORY OF RYANAIR STAKEHOLDING AND TAKEOVER ATTEMPTS	9
4.	CREATION OF A RELEVANT MERGER SITUATION	11
5.	MARKET CIRCUMSTANCES HAVE NOT APPRECIABLY CHANGED SINCE THE EC’S LAST ASSESSMENT	14
5.1.	EXTENSIVE OVERLAPS PERSIST BETWEEN THE TWO CARRIERS AND THEIR NETWORKS	14
5.1.1.	Approach to product and geographic markets.....	15
5.1.2.	Overlaps remain significant, and concentration has if anything increased.....	17
5.2.	RYANAIR AND AER LINGUS REMAIN CLOSE COMPETITORS	20
5.3.	BARRIERS TO ENTRY REMAIN HIGH	22
6.	THE COUNTERFACTUAL.....	25
7.	RYANAIR’S STAKE HAS DIRECT COMPETITIVE SIGNIFICANCE	27
7.1.	STAKEHOLDING AS PART OF AN ONGOING STRATEGY TO ACQUIRE AER LINGUS	27
7.2.	STAKEHOLDING AS A WAY OF EXERCISING MATERIAL INFLUENCE OVER AER LINGUS	30
7.2.1.	Incentives to influence Aer Lingus.....	30
7.2.2.	Ability to exert influence on Aer Lingus.....	31
8.	EFFECTS OF RYANAIR’S HAVING RIGHTS TO AER LINGUS’ PROFIT STREAMS ON RYANAIR’S OWN BEHAVIOUR	48
8.1.	AN ILLUSTRATION OF THE POTENTIAL COMPETITIVE EFFECT OF A MINORITY STAKE.....	48
8.2.	PRICE PRESSURE INDICES SUGGEST UPWARD PRESSURE ON FARES	49
9.	IMPORTANCE OF A FORWARD-LOOKING ASSESSMENT, AND LIMITED INSIGHTS FROM ROUTE PRICING STUDIES	51
9.1.	KEY CRITERIA FOR THE ASSESSMENT ARE INCENTIVES AND ABILITY TO ACT IN FUTURE	51
9.2.	LIMITED INSIGHTS FROM EMPIRICAL PRICING STUDIES	52
10.	AER LINGUS: THE PAST AND THE FUTURE.....	54
	ANNEX 1 – INTERFERENCES BY RYANAIR USING ITS MINORITY SHAREHOLDING.....	57
	ANNEX 2 - BACKGROUND INFORMATION ON RYANAIR’S INCENTIVES TO COMPETE THROUGH PARTIAL RIGHT TO AER LINGUS PROFIT STREAM.....	61

1. Summary and overview

1. Ryanair acquired the bulk of its stake in Aer Lingus nearly six years ago, in support of its first hostile takeover bid for its rival Aer Lingus. Prevented from proceeding by the European Commission's prohibition in June 2007, it has continued to pursue Aer Lingus, making a second abortive bid in late 2008. Ever since the European Commission's prohibition decision, Ryanair has acted as a disruptive and hostile shareholder, its shareholding acting as a deterrent to further investment in or by Aer Lingus, blocking special resolutions and more generally serving as a platform to interfere in the running of its closest competitor. This ongoing conduct has been accompanied by a noisy campaign of public criticism against Aer Lingus management. The CC will assess for itself the OFT's findings that this has weakened Aer Lingus as a competitor, with detrimental effects on competition both on routes where the two carriers already overlap and on dynamic competition, i.e., in the rivalry to open new routes.
2. Just a few days after the present reference to the CC was made, Ryanair launched a third hostile bid for Aer Lingus. In doing so, Ryanair claims to have pre-empted the CC's authority to investigate, since the European Commission has jurisdiction over the attempt to acquire full control. The legalities of that manoeuvre have been argued separately, and it is sufficient to note here that the timing betrays Ryanair's desperation to avoid the CC's scrutiny.¹ The CC is now for all practical purposes the only competition agency with the opportunity to adjudicate on Ryanair's shareholding in its competitor and with the necessary powers to put an end to Ryanair's siege and harassment of Aer Lingus.
3. The CC, as a newcomer to this saga, may legitimately ask two questions: why is the UK the forum for this to be resolved; and why has it taken so long for the case to come forward?
4. A short answer to the first point is that the Enterprise Act provides for control of minority shareholdings, unlike the ECMR and unlike most other systems of national merger control. And that both airlines carry on business in the UK. But the UK relevance is much more substantive than a mere jurisdictional truism. Aer Lingus holds the fourth largest portfolio of slots at Heathrow. Both carriers have UK bases, so serving large numbers of UK passengers as well as passengers inbound to the UK for

¹ Ryanair has been free to make a bid for Aer Lingus since January 2010 (twelve months since its previous bid lapsed).

business and pleasure. Both carriers fly UK domestic routes in addition to inbound/outbound international flights. In fact 9 of the 35 routes considered problematic by the European Commission in its 2007 prohibition included a UK airport, representing 58% of seat capacity on the 35 routes in Summer 2007. The Commission noted that these were among the most important routes as regard the number of passengers and frequencies.

5. It can be added that both Aer Lingus and Ryanair maintain secondary listings on the London Stock Exchange. With all these elements it will be clear to the CC that not only is there substantial UK interest in restoring unfettered competition between Aer Lingus and Ryanair, but that there will be no territorial enforcement difficulty if, at the end of the process, Ryanair is required to sell down its holding. Both carriers are subject to the jurisdiction of the UK courts and Aer Lingus will for its part be ready and willing to comply with instructions to it regarding changes to its share register.
6. As to the question of delay, the OFT took the view that it could not begin to investigate the minority shareholding for so long as litigation was continuing in the EU's Court of First Instance in Luxembourg around the 2007 ECMR prohibition. So it was only in September 2010 that the OFT opened its investigation. The delay since then has been caused by Ryanair's attempt to block the OFT investigation as being out of time. Having lost on that point through the UK appeals process, and prevented from achieving further delay by the Supreme Court's refusal to hear a final appeal or refer the case to Luxembourg, Ryanair has sought another means of blocking UK controls, namely its latest hostile bid. The vice of this situation will be clear to the CC: the longer the minority shareholding remains in place, the longer it will continue to produce its harmful effects. Competition delayed is competition that cannot be restored for the past; but it can be upheld for the future.
7. This would be a concern in any industry, but it is a particular concern in the aviation sector. There have been a series of consolidations among airlines in the recent economic downturn. The CC will be able to verify, in the course of its Inquiry, that Ryanair's presence on the Aer Lingus share register and outspoken publicity campaigns have been an impediment to Aer Lingus' freedom of manoeuvre in this critical phase, depriving Aer Lingus of the full range of transactional options and deterring third parties from engaging in negotiations. Ryanair cannot take over Aer Lingus, but it has been able to impede Aer Lingus from charting its own independent course. That impediment continues to operate, and every week lost in removing it is a week of detriment to UK consumers and the UK economy.
8. [CONFIDENTIAL]
9. Looking at a wider historical canvas, there is a bitter irony in seeing Ryanair labour so hard to suppress competition. Ryanair itself is a central beneficiary of the EU liberalisation of air transport. It has been an undoubted success and deserves credit for

its very direct role in Aer Lingus' rebirth as an efficient competitor. At the time Ryanair was still emerging, Aer Lingus was a carrier in the mould of the traditional flag carrier, but it was brought to the brink of insolvency by Ryanair's ruthless style and emphasis on cost-cutting. Today Aer Lingus operates profitably with ambitions to expand, employing many of the techniques pioneered by Ryanair: web-based bookings, one-way pricing, emphasis on ancillary income (luggage charges, sale of meals on board, etc.). It competes with Ryanair on a large number of routes, offering quality and service differentials (most importantly centrally located airports, allocated seating, and better customer service) while also maintaining a price tension that holds Ryanair's own pricing in check: this was tested and clearly verified by the European Commission. Yet Ryanair seems determined to stamp out this competition from Aer Lingus.

10. The OFT has undertaken a careful investigation, documented at length in its reasons for reference that were published on Friday 6 July. Aer Lingus agrees fully with the conclusions it reached. The OFT needed to satisfy itself only on the "is or may be" standard, and formally its findings are of course so worded. Nevertheless the evidence it cites is detailed, and its reasoning is cogent. Aer Lingus will not in this submission seek to recap all the ground covered by the OFT, believing rather that the OFT demonstrated its case easily to the "is" part of the standard, and knowing that the CC has full access to the evidence and working papers of the OFT. Aer Lingus would very readily assist the CC if there are specific aspects of the OFT's findings on which Aer Lingus' comments would be helpful.
11. Instead Aer Lingus believes it can best assist the Inquiry Group to form its own view of the matter by setting out the present free-form submissions, not modelled around the OFT's document. We have attempted also to do so succinctly, and look forward to the opportunity to develop the themes of interest to the Inquiry Group in the course of the dialogue in the coming months.
12. There is just one point championed by the OFT which Aer Lingus would wish to emphasise at the outset, namely that the relevant test under the Enterprise Act is the *ability* of Ryanair to exercise a material influence. The CC has before it the evidence of the last five years in which that influence has indeed been exercised, and produced harmful effects. However the question is also a prospective one, in which the CC must anticipate the manner in which that ability may be exercised in the future. Ryanair's strategy since 2006 has self-evidently been to besiege Aer Lingus, denigrating and weakening its target in the periods between the repeated attempts to move to full control. But that is not the only strategy available to it as a minority shareholder. Aer Lingus for its part has remained determined to maintain its autonomy, resisting Ryanair's incursions to the extent possible. [CONFIDENTIAL] The likely sale of the government's shareholding only increases these uncertainties. In assessing the present

merger situation the CC must be alive to the future while also examining the lessons of the past.

13. We look forward to assisting the Group in its evaluation of this case.

2. Background on Aer Lingus

14. Aer Lingus was incorporated in 1936 as the national airline of Ireland. Currently it operates 45 aircraft and it carried 10.4 million passengers in 2011. Aer Lingus will operate 108 routes directly serving 70 unique destinations across Ireland, the UK, Continental Europe, and the USA during the IATA Summer 2012 season of which 17 are to and/or from a UK airport. It is based principally at Dublin Airport where it operates a substantial portion of the scheduled flights from the airport. In the UK, Aer Lingus has bases at London Gatwick and Belfast airports. Aer Lingus also has a significant presence at London Heathrow where it is now the fourth largest carrier in terms of departures to Europe.
15. Aer Lingus operated as a traditional full service carrier until 2001. Post 9/11 it introduced a low fares model to compete with low cost carriers. Following the global economic and financial crisis in 2008, Aer Lingus initiated a review of its business model following which management concluded that it needed to modify its strategic direction. Since 2009, Aer Lingus has emphasised its positioning as a “value carrier” between the low cost and full service carriers, with a strong core product and offering additional paid options. As such, Aer Lingus targets both leisure / non-time sensitive and business / time sensitive passengers.
16. Aer Lingus is committed to serving airports located at convenient, central locations which enhance connectivity for customers. This airport selection is offered at more competitive prices than most other European legacy carriers. While the majority of Aer Lingus’ traffic is point to point, Aer Lingus also facilitates connecting traffic to worldwide destinations through its hub in Dublin and its codeshare arrangements with partner airlines.
17. Aer Lingus was a member of the oneworld alliance from 2000 to 2007. Aer Lingus’ partner relations strategy is not to operate point-to-point codeshare relationships with other airlines but rather to have a series of connecting codeshare relationships at key hub airports. Currently, Aer Lingus has such connecting codeshare agreements with BA at London Heathrow, KLM Royal Dutch Airlines (“KLM”) at Amsterdam Schiphol and United Airlines (“UA”) at Chicago’s O’Hare. Aer Lingus is also currently in negotiations with Etihad with regard to interlining and codeshare arrangements. This diverse range of partners epitomises Aer Lingus’ concept of “open network architecture” whereby its neutrality allows it to partner across alliances and offer connectivity through major hubs to worldwide destinations in addition to carrying point-to-point traffic.
18. Prior to its initial public offer (IPO) Aer Lingus was owned by the Irish Government (85%) and its employee trust ESOT (15%). The IPO of Aer Lingus took place on 2 October 2006, and the shares were listed on Dublin and London stock exchanges.

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19. Aer Lingus and Aer Arann entered into a franchise agreement in January 2010 which was further expanded in early 2012. Under this franchise arrangement, Aer Arann operates a number of routes under the “Aer Lingus Regional” brand.
20. Aer Lingus is actively considering expansion onto further UK domestic routes, through taking up slots released under the IAG/bmi commitments² to operate London to Edinburgh. Aer Lingus intends that the Heathrow - Edinburgh route will be a focus of future growth which will solidify and build on Aer Lingus’ existing established presence, brand, and product positioning in the UK. [CONFIDENTIAL]
21. The table below lists Aer Lingus’ main shareholders (i.e., those whose shareholding is greater 2 per cent) as of 4 May 2012.

Shareholder	Holding (per cent)
Ryanair	29.8
Irish Government (Minister for Finance)	25.1
Denis O’Brien	3.77
Etihad	2.987
Irish Life Investments	2.88
Pilots Pension Scheme	2.25

² See European Commission Press Release, dated 30 March 2012, “Commission approves acquisition of British Midlands (bmi) by IAG subject to conditions”; available at <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/12/338>.

3. History of Ryanair stakeholding and takeover attempts

22. The section briefly sets out the history of Ryanair's attempts to acquire Aer Lingus, which began at the time of Aer Lingus' IPO of October 2006 on the Dublin and London stock exchanges. It also traces Ryanair's behaviour as a dissident shareholder since it was left with its minority stake following the failed 2006 offer.
23. Within three days of the IPO Ryanair had built up a stake of 19.16%. On 5 October Ryanair announced its intention to launch an unsolicited bid for Aer Lingus. On 23 October 2006 Ryanair officially launched its hostile takeover. The concentration was notified to the European Commission ("EC") on 30 October.
24. Under the Irish Takeover rules, Ryanair could continue to acquire shares following the bid, and by the end of November 2006 Ryanair had acquired 25.2% of the share capital of Aer Lingus. Through subsequent purchases Ryanair has increased its shareholding in Aer Lingus to its current level of 29.82%.
25. Following a full investigation, the EC prohibited Ryanair's takeover attempt on 27 June 2007 as incompatible with the common market. In its prohibition decision the EC noted that on a very large number of routes where the two airlines competed, there would be a significant impediment to effective competition, indeed in many cases the creation of a full monopoly. A significant proportion of these routes involved a UK airport. Ryanair offered numerous remedy packages in an attempt to eliminate the identified harm to competition that would result from a combination of Ryanair and Aer Lingus; however, none were sufficient to overcome the loss of competition.
26. In various combinations, the remedies proposals involved the following: (1) slots for new entrants on specific routes, (i.e., airport-pair O&Ds as explained in section 5.1.1 below), including slots for the Dublin – London Heathrow route and slots intended to be sufficient for an entrant to establish a base of 6 aircraft at Dublin Airport, (2) finding an up-front buyer for the divested slots prior to closing, (3) agreements not to increase capacity or frequencies following entry on one of these routes, and (4) agreements to reduce fares and fuel surcharges and relating to branding.
27. The EC based its rejection of Ryanair's various slot remedy proposals on a number of factors including that: (1) the remedies did not cover all of the problem routes, (2) they did not provide enough slots to establish a sufficient base at Dublin, (3) they were unlikely to attract new entry, and (4) there was no indication that entry would occur or that any entrant would restore the needed competition.
28. Following the prohibition, on 11 October 2007 the EC declined to mandate the divestment of the minority stake on the grounds that, since the stake was not by itself a "concentration with a community dimension," it did not have the power to do so.

29. Ryanair appealed the prohibition, and Aer Lingus appealed the EC's failure to consider the divestment of the minority stake. On 6 July 2010, the European Court of First Instance (General Court) upheld the EC on both fronts.
30. During the appeal process, Ryanair launched a second hostile takeover attempt in December 2008, but abandoned this bid in January 2009, after the Irish Government indicated it would vote against the bid due to the continuing competition concerns.
31. Following the conclusion of the appeal process, as the OFT explains in detail in paragraphs 75-82 of its reference decision, the OFT initiated its own investigation into Ryanair's minority shareholding in Aer Lingus. After a lengthy process due to protracted litigation by Ryanair via the CAT, Court of Appeal, and an attempted appeal to the Supreme Court, the OFT referred the matter to the Competition Commission on 15 June 2012.
32. On 19 June 2012 Ryanair launched a third unsolicited bid to acquire 100% of Aer Lingus. Upon evaluation of this offer the Board of Aer Lingus issued a statement (on 20 June 2012) advising Aer Lingus shareholders to take no action in relation to this offer. It is surely no coincidence that Ryanair's third bid came just a few days after the reference to the CC. Ryanair had been at liberty since January 2010 to launch a bid,³ but had repeatedly denied any interest in doing so, e.g., "*O'Leary also said Ryanair had no plans to place another offer for Aer Lingus. Unless the Irish government changes its mind on its stance not to sell its 25-percent stake to Ryanair a bid would not be feasible, he said, 'We have frankly given up'*".⁴

O'Leary open to selling Aer Lingus stake to rival

Ryanair chief executive Michael O'Leary has again ruled out mounting a third bid for Aer Lingus but conceded that he would be willing to sit down with any rival interested in buying the airline if it wanted to acquire Ryanair's near 30pc stake in the carrier.

Speaking to the Irish Independent from Oslo yesterday, Mr O'Leary said that, despite comments he made to a German newspaper this week, he was not contemplating any fresh assault on Aer Lingus.

Source: *O'Leary open to selling Aer Lingus stake to rival*" Irish Independent, 20 October 2010.

Once, however, it had exhausted all possible delays to the OFT process via court appeals, it has resorted, cynically, to the device of a further bid, immediately asserting

³ 12 months after the lapse of its second abortive bid

⁴ MLex article dated 6 December 2011 "*Ryanair's O'Leary confident of keeping Aer Lingus stake despite OFT scrutiny*".

to the CC that its jurisdiction thereby had been pre-empted. The CC has today rejected that contention.

33. Meanwhile, since its first failed takeover bid, Ryanair has engaged in a campaign of distraction and disruption to weaken its competitor. While nominally acting as a shareholder, in reality Ryanair has deployed shareholder rights in pursuit of its interests as a competitor, with the purpose and effect to constrain Aer Lingus' flexibility and reduce its ability to compete. It has brought a series of legal actions and regulatory complaints about supposed infringements of its shareholders rights, all uniformly unsuccessful. The list of Ryanair's interferences is long, included as **Annex 1**, and will not be fully recounted here. Among other interferences, Ryanair has or has attempted to do the following:

- Block special resolutions relating to the disapplication of pre-emption rights, which restricts Aer Lingus' options regarding access to finance;
- Prevent Aer Lingus from entering or exiting specific routes;
- Prevent Aer Lingus from purchasing new aircraft;
- Lower the salaries for directors and the chairman;
- Oblige Aer Lingus to surrender facilities (i.e., Hangar 6 at Dublin Airport) in order for Ryanair to use them;
- Compel Aer Lingus into disclosing competitively sensitive information; and
- Frustrate Aer Lingus' resolution of issues relating to pensions.

34. Over and above the specific actions undertaken by Ryanair, its very presence on Aer Lingus' share register has a fundamentally adverse effect on Aer Lingus. Its noisy and belligerent conduct serves as a deterrent to third parties who might otherwise engage with Aer Lingus. The OFT cites for example (see OFT Decision para 152) an occasion when Aer Lingus was unable to progress with a slot-swap arrangement due to a third party's concern that Ryanair would have the ability to block such an arrangement. See further below at para 135ff.

35. [CONFIDENTIAL]

4. Creation of a relevant merger situation

36. The relevant merger situation in this case is clearly established and we can be brief on this formal jurisdictional aspect. It is a case on facts which are much more compelling than those for example in BSkyB/ITV, which was itself a case in which material influence was confidently found, and upheld on appeal.

37. To be complete nevertheless we set out here the jurisdictional requirements, referring for more detail to the OFT's detailed assessment at para 9ff:

- Both Aer Lingus and Ryanair **carry on business** in the United Kingdom.
 - Both the **share of supply test** and the alternative **turnover** test are satisfied: as OFT note (para 71), the two parties together account for more than 25% of passengers flown between the UK and Ireland and over 65% of flights. As to turnover, Aer Lingus' sales in the UK in 2011 were substantially in excess of £70m.
 - The **timeliness** of the OFT's reference, under s.122 EA, has been definitively affirmed in the Court of Appeal, with the Supreme Court refusing permission for further appeal.
38. Ryanair's **material influence** over Aer Lingus is sufficiently demonstrated by its *de jure* ability, with a 29.82% shareholding, to block special resolutions. Whereas in BSkyB/ITV many pages of evidence and reasoning were required to demonstrate the likely ability of BSkyB to do so with a stake below the critical 25% level, in this case it is a fact that Ryanair has the formal ability to do so. And specifically it has blocked, at the AGMs in each of 2007, 2008,⁵ 2009, 2010, 2011 and 2012, precisely the special resolution on which the CC focused in BSkyB, namely for the disapplication of pre-emption rights on share issues, which is a critical tool for fund-raising. Further special resolutions have also been blocked - see OFT Decision at para 20. And the ability to block such resolutions in future carries with it the specific ability to block various forms of corporate reorganisation, including certain forms of merger than might be advantageous for Aer Lingus. This topic is addressed further at para 100ff.
39. Further support for this finding, were it needed, is present in the specific voting mechanisms applicable to dealings in Heathrow slots, foreseen in Aer Lingus' Articles of Association (see OFT at para 49). These slots are of fundamental importance in Aer Lingus' operations, as well as being valuable assets that Aer Lingus might wish to deploy for purpose of trading against slots elsewhere (see OFT at para 50), or for secured fundraising (see OFT at para 51). Ryanair is just short of the formal numerical ability to block such resolutions, but with the reality that turn-out at AGMs of a listed company is always substantially below 100%, Ryanair has the *de facto* certainty of being able to do so. This topic is addressed further at para 130ff.
40. While these elements fulfil the jurisdictional test, the OFT has undertaken a valuable additional examination (OFT Decision at para 54ff) of the likelihood of Ryanair being able to block not just *special* resolutions or LHR-slot resolutions, but also *ordinary* resolutions. This has led it onto a careful evaluation of turn-out levels and voting patterns, similar to that undertaken by the CC in BSkyB – where the purpose though was to establish the prospect of BSkyB blocking a special resolution. The relevance of

⁵ The relevant resolution was withdrawn at the 2008 AGM by the Aer Lingus chairman as Ryanair had lodged a proxy against this and other resolutions meaning that they would inevitably be defeated.

the examination in this case will lie, Aer Lingus submits, in the eventual assessment of the divestment to be required of Ryanair, given the reality of poor turn-out at AGMs – notably after dispersal of the former ESOT block. We do not extend the present section by dwelling on the topic here.

41. Nor do we extend this jurisdictional section by debating whether Ryanair’s disruptive conduct is in itself a demonstration of material influence. It is true that Ryanair, as the largest shareholder and a player with significant industry expertise, is in a position to influence other shareholders and indeed Aer Lingus itself: see OFT at 68 and BSKyB at para 3.58. But it is sufficient to examine that conduct within the topic of substantial lessening of competition.
42. Ryanair has frequently sought to obfuscate on the issue of material influence, wilfully confusing it with the test of control under the ECMR. The CC will need little assistance in blowing away this smokescreen. The fact that the minority shareholding did not by itself confer “decisive influence” under the ECMR, i.e., that it did not constitute a “concentration” at EU level, was the basis for the European Commission’s

RYANAIR WELCOMES UK COMPETITION COMMISSION REFERENCE

**CONFIDENT THAT CC WILL AGREE WITH EU COMMISSION, LEAVING RYANAIR'S SIX YEAR OLD
MINORITY STAKE UNCHANGED**

Ryanair, Europe’s only ultra-low cost airline, today (15th June) welcomed the decision by the OFT to refer Ryanair’s six year old minority (29%) stake in Aer Lingus to the UK Competition Commission for review. Ryanair is confident that the CC will agree with the EU Commission which found in 2007 – over five years ago – that since Ryanair has neither “*de facto or de jure control*” in Aer Lingus, it should not be forced to sell down its 29% stake

Source: Ryanair news release of 15 June 2012, “*Ryanair Welcomes UK Competition Commission Reference*”.

inability to address it under Art 8(4) ECMR, but it tells us nothing about the application of the, lower, test of material influence under the UK statute.⁶ It is precisely because the shareholding does not confer ECMR-type decisive influence that the present reference is before the CC.

⁶ Similarly Ryanair has frequently recalled the ruling of the President of the EU’s Court of First Instance rejecting Aer Lingus’ application for interim measures, as an argument for denying the lessening of competition relevant to application of the Enterprise Act. Of course the test relevant to interim measures in the CFI was a quite different one, requiring a demonstration of “serious and irreparable harm”.

5. Market circumstances have not appreciably changed since the EC's last assessment

43. The circumstances which motivated the EC's conclusion in 2007 that a takeover of Aer Lingus by Ryanair would have led to significant competitive harm hold true to this day. Contrary to Ryanair's recent statements that "*circumstances have changed materially since [Ryanair's] first unsuccessful bid for Aer Lingus in 2006*"⁷, there has been in fact no material change in the market to justify a different conclusion on the extent to which Ryanair and Aer Lingus directly compete with one another. Indeed, to the extent that changes have occurred in the market, these changes have made the case for continued competition between Aer Lingus and Ryanair even more compelling. As described below, and recently confirmed by the OFT, the competition between the two carriers remains close, and this is also true specifically for traffic between the UK and Ireland. There has been no material entry by third party carriers since the prohibition decision and many of those third party carriers previously present on the overlap routes have exited. This is the relevant background against which the competitive effects of Ryanair's 29.82% stake need to be assessed.
44. This section first defines the relevant markets and describes the extent of the current overlaps between Ryanair and Aer Lingus on UK routes. Section 5.2 then explains that Ryanair and Aer Lingus are each other's closest competitors in the markets in question in terms of business model, but also because each is best placed as a potential entrant to many routes that the other currently serves, and to develop new routes of interest to the same potential passenger pool. This means that their current market shares on individual routes underestimate the market power that arises from a loss of competition between them. Finally, Section 5.3 explains that barriers to entry remain high, and therefore there can be no realistic expectation that third party entry could re-instate the loss of competition which arises from the softening of Ryanair and Aer Lingus' commercial rivalry resulting from the stake.

5.1. Extensive overlaps persist between the two carriers and their networks

45. There are at present significant overlaps in the operations of the two carriers. These imply high levels of concentration and substantial shares in a number of relevant markets; indeed, there are a number of markets in which Ryanair and Aer Lingus are the *only* competitors.

⁷ Cash Offer by Coinside Limited, a wholly owned subsidiary of Ryanair Holdings plc, for Aer Lingus Group plc, p2; available online at http://www.ryanair.com/doc/news/2012/aerlingus_20120619.pdf.

5.1.1. Approach to product and geographic markets

46. There is extensive precedent by numerous regulators⁸ which has defined the relevant market for passenger transport services on the basis of a “point of origin/point of destination” (O&D) approach. This reflects a demand-side perspective in which the scope of the relevant market ultimately depends on the extent to which passengers regard different services for travelling from a point of origin to a point of destination as close substitutes: in particular, whether passengers regard airlines flying to the same destination but perhaps to a different airport, or airlines offering different service levels (including in terms of frequencies, and full-service vs. “low-frills” airlines⁹), as closely substitutable.¹⁰
47. With regard to the **geographic market**, an obvious issue for market definition is the extent to which passengers consider flights to the same urban area – as opposed to the same airport – as good enough substitutes given their requirements. If there is significant “airport specificity” in their preferences, then the market will encompass only “airport pairs”; if there is substantial substitutability between (at least some) airports serving the same urban area, then the assessment needs to refer to “city pairs”.
48. The question of substitutability between airports immediately also raises the question of substitutability *for whom*. Locational preferences of passengers for a given airport will vary widely with reference to a number of characteristics; in particular whether they are “time sensitive” (in which case travel time and connectivity to the airport will matter significantly more, as will the number of daily frequencies in case they need to reschedule their flight at short notice). These issues are relevant to the **product market** definition but remain related to geographic market, given the inter-related pattern of substitution (for example, services for time-sensitive and non-time sensitive passengers could have different geographic markets).
49. Aer Lingus considers below the appropriate product and geographic market definition in this case.

Relevant product market

50. Aer Lingus believes that for purposes of the present case it is not appropriate to further segment point-to-point scheduled passengers along any dimension. Whilst various EC (and OFT) decisions have previously concluded that it may be appropriate

8 See various EC decisions, as well as the recent OFT decision.

9 Also referred to as “low cost carriers” (LCCs). Terminology has become more varied over time, for instance Ryanair brands itself as an “ultra low cost carrier” and the EC’s 2007 decision makes reference to “mid-frills” airlines.

10 In general indirect services (which involve transiting) are not substitutable for direct (“point-to-point”) services on short-haul routes. In some cases train or ferry services may be a substitute for air services but this is not the case for any routes currently at issue given the much longer travelling time.

to distinguish between different types of passengers, that is not the case here. In particular (as the EC and OFT found in relation to this case) it is not appropriate to define separate markets for categories of passengers such as time-sensitive (TS) and non-time sensitive (NTS), business/leisure, or “late booking” passengers. The EC noted that both Ryanair and Aer Lingus only offered one-way restricted tickets and did not attempt to discriminate between groups of passengers. It remains the case that the vast majority of Aer Lingus’ short haul fares are one-way restricted tickets, with flexible fares representing [CONFIDENTIAL] of total Aer Lingus internet bookings on short-haul routes.¹¹

51. Aer Lingus also believes that whilst it is appropriate to include all scheduled airlines within the relevant market (albeit that closeness of competition will not be uniform depending on various factors; see section 5.2 below), it is not appropriate to include charter services. The majority of the charter airline seats are captive to tour operators, and direct sale to consumers of the air transport service only (“dry seats”) is very limited: in 2007 the Commission found that in no case it exceeded 5% of all seats offered by charters.

Relevant geographic market

52. Whether airports are demand-side substitutes (and therefore can be part of the same market) needs to be assessed on a case-by-case basis. Aer Lingus considers that there has been no material change in circumstances over those outlined in the EC’s 2007 decision, and accordingly that the following sets of UK airports are demand-side substitutes (and therefore part of distinct markets):
- Heathrow (LHR), Gatwick (LGW), Stansted (STN), Luton (LTN) and City (LCY) for London;
 - Manchester (MAN), Liverpool (LPL) and Leeds Bradford (LBA) airports; and
 - Birmingham (BHX) and East Midlands (EMA) airports;
53. Aer Lingus also believes that O&D pairs involving Belfast and Derry are substitutes (as considered by the OFT on a cautious basis).

¹¹ Aer Lingus introduced a “flexi” fare product in late 2008, specifically targeted towards time sensitive / business passengers, and it offers fully changeable and refundable fares together with certain product enhancements such as lounge access, and free bags and seat selection. These fares represent a very small proportion of Aer Lingus’ overall ticket sales and do not, by any measure, capture all time sensitive or business passengers. In particular, “flexi” fares only represented approximately [CONFIDENTIAL] of total Aer Lingus internet bookings on short haul routes and [CONFIDENTIAL] of internet bookings on the Dublin-Heathrow route in January-June 2012. The vast majority of Aer Lingus’ short haul fares are therefore subject to the same terms, conditions and restrictions and are non-refundable. As a result, Aer Lingus does not collect or possess data which generally distinguishes between TS and NTS passengers on its short haul routes. “Flexi” fares are purchased by a very small proportion of Aer Lingus passengers and segmentation on this basis would not be meaningful.

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54. When considering the relevant geographic market it is also important to recognise that, for O&D pairs involving different airports to be in the same market, these airports need not be substitutes for *all* customers. It is doubtless the case that certain customers may have strong preferences to fly to, say, Gatwick and would not instead fly to, say, Stansted in the face of a small but significant and non-transitory increase in price (“SSNIP”). However, as long as there are sufficient customers who would switch to make such a SSNIP unprofitable, the airports will be deemed to belong to the same relevant market.
55. Aer Lingus also notes that there are indications that a wider candidate market for “air transport between the UK and Ireland” (alternatively Dublin) should also be considered. Both Ryanair and Aer Lingus are Irish airlines with significant operations to and from Ireland and in particular Dublin. Ryanair and Aer Lingus are uniquely positioned to enter or expand on routes between Ireland and the UK and have strong brand recognition amongst Anglo-Irish consumers in particular. Ryanair and Aer Lingus are strong potential entrants on such routes. Aer Lingus therefore submits that consideration of O&D pairs and a wider UK/Ireland market may be appropriate in this case. This issue is considered further in section 5.2.
56. Finally, Aer Lingus notes that recently (in *IAG/BMI*, M.6447) the EC also recognised the possibility that market power in airline mergers may also arise (over and above route-level power) from high levels of concentration at a given airport, leading to material premia at airports which are congested and where an airline accounts for a large share of slots or of other key assets.¹² There is indeed a significant empirical economic literature showing quite clearly that airport dominance – especially at capacity-constrained airports – can have anticompetitive effects of its own that extend above and beyond the anticompetitive effects stemming from route overlap. Given congestion and the overwhelming dominance of Ryanair and Aer Lingus at Dublin airport, this may be a relevant issue for consideration also in the present case.

5.1.2. Overlaps remain significant, and concentration has if anything increased

57. The EC prohibition decision of 2007 found that Ryanair and Aer Lingus overlapped on 35 routes, and were the only competitors on 22 of the overlap routes. The overlap routes included nine routes between Ireland and the UK, and on five of these they were the only competitors. The EC found that the concentration would result in a significant impediment to effective competition on each of these nine overlap routes. Whilst the individual details of overlap routes have changed somewhat, there is still extensive overlap between Aer Lingus and Ryanair and the EC’s original conclusion still very much holds.

12 Section VI.2 of M.6447 *IAG/BMI*.

58. Across their wider networks, Aer Lingus and Ryanair overlap on approximately 49 routes; on 33 of these routes, they are the only competitors. They are by far the largest airlines at Dublin, Cork and Shannon, together accounting for 84%, 79% and 80% respectively of short-haul seat capacity at these airports in Summer 2012.
59. There are currently eleven overlap routes between Aer Lingus and Ryanair involving the UK. These routes are relatively “thick” and account for 59% of the seat capacity of all 49 overlap routes in Summer 2012. The overlap between Ryanair and Aer Lingus is thus even more significant than at the time of the EC decision with high levels of concentration. As the OFT has most recently found, there has been no material change in circumstances which may support the conclusion that loss of competition between Ryanair and Aer Lingus would not result in a significant impediment to effective competition on these routes.
60. Moreover, the significance of the overlap between the two carriers persists whatever the precise market segmentation. For instance Aer Lingus and Ryanair overlap on five airport pairs; on all of these pairs they are the only competitors.¹³ Thus even under the assumption that the relevant geographic market was only airport pairs, and that there is segmentation between TS and NTS passengers, significant overlaps remain.

¹³ Birmingham to Dublin, Manchester to Dublin, Edinburgh to Dublin, London Gatwick to Dublin, and London Gatwick to Cork.

Table 1: Market shares by seat capacity, Summer 2012

Route	Share of seat capacity, Summer 2012			Other Competitors
	Aer Lingus	Ryanair	Combined	
London to Cork	57%	43%	100%	None
London to Shannon	48%	52%	100%	None
London to Knock	35%	65%	100%	None
Manchester/Liverpool/Leeds to Dublin	26%	74%	100%	None
Birmingham/East Midlands to Dublin	36%	64%	100%	None
London to Dublin	46%	39%	84%	BA/bmi (10%), CityJet (5%)
Edinburgh to Dublin	18%	58%	76%	Aer Lingus Regional (24%) ^[2]
Belfast/Derry to Tenerife ^[1]	85%	15%	100%	Charter airlines also present
Belfast/Derry to Faro	32%	14%	46%	easyJet (48%), bmibaby (3%) ^[3] , Jet2 (3%); charter airline also present
London to Belfast/Derry	15%	7%	21%	easyJet (41%), BA/bmi (22%), Flybe (13%), bmibaby (2%) ^[3]
Belfast/Derry to Alicante/Murcia	15%	4%	19%	easyJet (40%), Jet2 (36%), bmibaby (5%) ^[3]

Source: Schedule data.

[1] Ryanair operates this route in the summer season only. The OFT decision states that charter airlines are also materially present.

[2] As explained in Section 3 Aer Lingus Regional brand is operated by Aer Arann, an independent airline, as a franchise on certain regional routes.

[3] bmibaby has ceased operations on these routes.

61. It is notable that:

- On five of these routes Ryanair and Aer Lingus are the *only* operators (Manchester-Dublin, Birmingham-Dublin, and London to Cork, Shannon, and Knock);

- On the London-Dublin, Ryanair and Aer Lingus together account for 86% of passengers on the route and are by far the largest operators.¹⁴
62. Aer Lingus submits that, even absent the detailed discussion of the closeness of competition given below, it is irrefutable that Aer Lingus and Ryanair compete closely and intensely on these six routes. Aer Lingus also believes that there is the potential for competitive harm on other overlap routes, where market shares may understate the closeness of competition between Ryanair and Aer Lingus.

Aer Lingus Regional

63. Aer Arann operates a number of routes under the Aer Lingus Regional franchise, many of which were operated directly by Aer Lingus prior to 2010.¹⁵ A number of these routes are operated in competition with Ryanair.¹⁶
64. The Aer Lingus Regional franchise forms a key part of Aer Lingus' strategy for so-called UK Provincial ("UKP") routes, enabling Aer Lingus to offer increased services (higher frequency or serving thinner routes). Flights are operated under the Aer Lingus Regional brand (which the customers closely associate with the Aer Lingus brand), are distributed exclusively through the Aer Lingus website, and are included in Aer Lingus network advertising and promotions. By using Aer Lingus Regional brand and the associated standards of service quality for the flights it operates and by accessing Aer Lingus' distribution system, Aer Arann is able to operate routes in competition with Ryanair which would otherwise not be possible. Accordingly, at a brand level the competition between Aer Lingus and Ryanair includes those routes operated by Aer Arann under the Aer Lingus Regional brand and is broader than that indicated by the routes on which Aer Lingus and Ryanair directly operate. As such, the competitive interaction between Aer Arann and Ryanair is also relevant to the Group's analysis.

5.2. Ryanair and Aer Lingus remain close competitors

65. Market shares are inevitably only a first indicator of market power, particularly where – as in airline transport – there are multiple dimensions of product differentiation and customer preferences are distributed across these dimensions in a complicated way. The interpretation of market shares thus needs to also factor in any similarities in the parties' offers which make them *closer* alternatives from the perspective of passengers

14 See OFT Decision –para 110.

15 A fuller description of the franchise agreement is given in section 2 above.

16 Birmingham/East Midlands to Knock; Manchester/Liverpool to Shannon and Cork; Glasgow to Dublin; Edinburgh to Dublin; Bristol to Dublin. Ryanair commences operating East Midlands to Cork on 1 September, forming an additional overlap with Aer Lingus Regional's flights from Birmingham to Cork.

(relative to services by other carriers to/from the same destinations). A number of features suggest Aer Lingus' services are close to those of Ryanair in a number of important ways, and thus that the competitive effects of Ryanair's shareholding are likely understated by the parties' respective market shares on individual routes, or bundles of routes. There are several grounds on which Aer Lingus and Ryanair should be deemed close competitors. Ryanair positions itself as a pure low-cost, no-frills service; and while Aer Lingus has somewhat moved away from a pure low-cost service in recent years towards a positioning as "value carrier", the main elements of their service offering are the same.¹⁷ For example, both operate a single type of aircraft,¹⁸ operate a single class (i.e., no business class), set prices on the basis of one-way fares, predominantly sell non-refundable tickets, realise most of their sales from the web, and charge for ancillary services (checked-in luggage, food and drink on-board, seat selection, etc.).¹⁹ There is some differentiation between Aer Lingus and Ryanair (for example, allocated seating is offered by Aer Lingus whilst this option is available for a limited number of seats on Ryanair flights, Ryanair tends to serve secondary airports and Aer Lingus "primary" airports), but this remains limited overall.

66. Other competing airlines are much more differentiated from Ryanair than Aer Lingus. For example, carriers such as BA (now owner of bmi) and CityJet are much more focussed on business customers and, in the case of BA, connecting traffic. They offer a "full service" product without additional charges and often utilising pricing rules in order to price-discriminate between time-sensitive and non-time sensitive customers (for example charging more for same-day returns or trips that do not incorporate a weekend). Smaller regional carriers such are not well-placed to compete with Aer Lingus and Ryanair as they typically operate smaller aircraft with a corresponding cost disadvantage. Aer Lingus and Ryanair are therefore very close competitors and each other's closest competitors on the relevant routes.
67. In addition, as the Commission recognised in its 2007 decision (and others subsequently), a critical dimension of competition in the airline industry is its "dynamic" nature: the entry of a carrier on a route it did not previously serve, as well as the development of entirely new routes. Airlines competing with each other tend to continually re-assess their route networks, entering potentially viable routes. The ability to enter is closely linked with the presence of a "base" at a given airport, as the

17 The description given here relates to Aer Lingus' short-haul services. See a fuller description of Aer Lingus' strategy at <http://corporate.aerlingus.com/companyprofile/ourstrategy/>.

18 Aer Lingus operates A319, A320 and A321 aircraft on short-haul routes, all part of the A320 family.

19 Certain Aer Lingus fare types include checked-in luggage and seat reservations; as these are more expensive than the basic fare there remains an effective charge.

availability and concentration of complementary assets (slots, aircraft, crew) at a “base airport” facilitates re-optimisation and makes entry on a route (or the launch of a new route) more feasible for an airline.

68. Because of this greater flexibility, airlines operating from a “base” at the same airport are recognised to have greater potential for launching services in competition with existing ones, and thus as providing a more effective competitive constraint on other airlines – being well placed to enter routes in response to a profit opportunity (e.g., attractive fares being charged by the rival on certain routes).²⁰ Again this was clearly recognised by the EC in its 2007 decision.²¹ Besides Ryanair, Aer Lingus is the only other airline with a significant base at Dublin, Shannon, and Cork airports, and Aer Lingus is thus the most significant potential entrant from the Ireland side on routes connecting the UK and the Republic of Ireland currently operated only by Ryanair, and vice-versa. Aer Lingus accordingly agrees with the OFT’s recently expressed view that the ease with which Ryanair and Aer Lingus can switch and reallocate capacity, enter, expand and exit on routes between the UK and Republic of Ireland, may be materially greater than any other airline.
69. In short, the competitive significance of the shareholding should be assessed not only in a static perspective, i.e., with reference to the current status of O&D route overlaps. Aer Lingus submits that potential competition on non-overlap routes involving the UK is also an important consideration, given that Ryanair and Aer Lingus are strong potential entrants on routes from their bases in the Republic of Ireland that they do not serve; as is dynamic competition, particularly with reference to a candidate market for UK-Ireland air transport.

5.3. Barriers to entry remain high

70. Aer Lingus believes that, as outlined in the OFT decision and the EC’s 2007 decision, there are a number of important entry barriers to operating flights in competition with Ryanair and/or Aer Lingus. Notwithstanding Ryanair’s recent public statements,²² Aer Lingus believes that capacity constraints remain a barrier to entry. In addition – as is implied but unsaid by Ryanair – further significant barriers to entry exist.

20 A carrier established at a base airport may also be better-placed to add new routes because it will have an existing customer base (corporates, agents, individuals enrolled in its frequent flyer programme) to whom to market the new routes, making it easier to attract passengers to the new route.

21 Paragraph 552.

22 Cash Offer by Coinside Limited, a wholly owned subsidiary of Ryanair Holdings plc, for Aer Lingus Group plc, p2; available online at http://www.ryanair.com/doc/news/2012/aerlingus_20120619.pdf.

Capacity constraints remain a barrier to entry

71. Dublin Airport is slot-constrained for peak morning slots (0630 – 0800). No carrier can establish an efficient and viable base at Dublin airport without a sufficient number of these peak hour departure slots. Airlines attempt to start operation as early as possible in order to maximise their aircraft utilisation, and the allocation of the peak morning slot may also impact scheduling for the remainder of the day. In addition, early-morning departures are key to attracting time-sensitive or business passengers. In the IATA 2011 summer season Aer Lingus had 55.3% of these peak hour departure slots and Ryanair had 33.3%. In the IATA winter season 2011 Aer Lingus had 61.7% peak hour departure slots and Ryanair 30.3%. Such slots are particularly important for airlines attempting to establish a base at Dublin.
72. In addition Heathrow is a notoriously congested airport, and Gatwick, Stansted, and London City as well as Manchester Airport, are “coordinated airports”, and as such may suffer capacity constraints.

Further significant barriers to entry exist

73. The EC 2007 decision found that critical entry barriers “go well beyond the problem of the partly congested airport” (para 784). Even if there were spare capacity at Dublin airport (*quod non*) this would still be far from sufficient to eliminate entry barriers.
74. Airlines operate from “bases” whereby a number of aircraft and crew are based at a certain airport, often along with various ancillary services. This affords airlines economies of scale and scope stemming from flexibility of assets at a base and the ability to spread fixed costs over many routes.²³ Aer Lingus operates all of its flights from one of its bases (Dublin, Cork, Shannon, Belfast, and London Gatwick). Aer Lingus believes that Ryanair does the same. As recognised by the EC²⁴, new point-to-point entry by an airline that does not have a base at either end of the route is unlikely. This constitutes a strong barrier to entry from the Irish end of any of the overlap routes.
75. Ryanair also has an established reputation for aggressive retaliation to entry. There are numerous examples where Ryanair has “attacked” the entrant by increasing

23 The EC recognised this in its 2007 decision, stating at paragraph 381 that: “Concentrating aircraft and traffic at certain bases can generate considerable cost savings and increased flexibility. In comparison to providing a point-to-point service on a single route without a base at either end, base operations provide numerous competitive advantages for the routes operated from that base. There are mainly two effects which arise from base operations. First, the base allows realising cost savings due to economies of scale and scope. Secondly, there is a “competition effect”, in that the airline can react more easily and more quickly to changes in supply and demand on routes out of this base. Dynamic reaction to the behaviour of competitors is therefore easier when operating from a base than outside a base.”

24 Section 7.8.3.4.

frequencies and capacity. For instance, the EC 2007 decision²⁵ outlines Ryanair's response to easyJet's attempt to enter the UK-Ireland market in 2005. easyJet entered the London-Cork, London-Knock and London-Shannon routes in January 2005 but exited the routes in 2006 following the reaction of Ryanair and no longer flies to Ireland. Ryanair's response involved significant capacity increases, often entering on direct airport-pair overlaps with easyJet, that drove down Ryanair's fares to €10-20 on the Cork and Shannon routes. The additional capacity was in some cases withdrawn after the exit of easyJet.²⁶

76. Ryanair and Aer Lingus also have well-established brands, particularly in the UK and Irish markets, affording them experience in the UK-Ireland market and marketing advantages and facilitating very high levels of online sales.

Entry is unlikely; further exit is plausible

77. Ryanair and Aer Lingus therefore have advantages deriving from their bases, well-established brands, and Ryanair's reputation for aggressive retaliation. No airline could realistically hope to be able to overcome these barriers to entry, and as noted by the OFT, there has been no material entry or increased capacity, other than by Aer Lingus and Ryanair, on UK-Ireland routes in the last five years. At the time of the EC review competitors "unanimously indicated that they would not even consider entering in direct competition with the merged entity on a significant scale" (para 784) and indeed no entry has materialised over the last five years. Such entry is even less likely given the marked decline in the economic environment since the EC's prohibition decision.
78. In fact, more common have been capacity reductions and exit by competitors. For example, BA exited the Dublin-London route, only recently returning to this route following its acquisition of bmi, and its commitment to this route (together with the Belfast – London Heathrow route) has been questioned. bmibaby has been shut down following its acquisition by BA and has already ceased to operate routes from Belfast. CityJet has also significantly reduced capacity since the EC's prohibition decision.

25 Section 7.8.5.

26 Go Airlines, the former low-cost subsidiary of BA, was also forced from the Irish market following an aggressive reaction by Ryanair to its entry between Dublin and Edinburgh/Prestwick.

6. The counterfactual

79. The OFT has assessed Ryanair's shareholding against a counterfactual in which Ryanair did not own any shares in Aer Lingus, taking into account evidence of marketplace dynamics that have occurred since the acquisition of the minority stake that were considered to be relevant to the assessment.
80. Aer Lingus agrees with the OFT's assessment and submits that the appropriate benchmark for assessing the effects of Ryanair's shareholding is a competitive situation in which Ryanair did not hold any stake in Aer Lingus. While Aer Lingus believes that absent Ryanair's stake it would have been better placed to participate in M&A activity, it is difficult to be certain about the extent to which such a possibility would have actually materialised in the period since Ryanair's acquisition of the stake. The relevant counterfactual therefore remains a situation in which Ryanair does not own any shares in Aer Lingus, and where the latter operates independently of any other airline.
81. Inevitably over the last six years there have been changes in the marketplace – reflected in changes to overlap routes related to the UK, changes in the parties' and other airlines' capacities on those routes, mergers involving competitors on UK-related routes and some evolution of Aer Lingus' product positioning. Many of these changes are however not specific to the shareholding (i.e., they would have occurred independently of the shareholding). Moreover, some changes in circumstances (such as the extent of route overlap) that might have occurred at least in part because of the shareholding would be hard to identify precisely.
82. In practical terms there are therefore only two options to choose from: the historic and the current overlap situations. However, as discussed in the relevant section of this submission, and recognised by the OFT, the degree of competitive interaction between Ryanair and Aer Lingus is similar, independent of whether the historic or the current overlap situation is considered. As such, both cases would lead to the same competitive assessment under a forward-looking exercise such as required here.
83. Given this, again for all practical purposes, the appropriate counterfactual can be taken to be the current market circumstances with the assumption that Ryanair held no stake in Aer Lingus. This does not of course imply that changes in circumstances (e.g., route overlap) that might be linked to the shareholding should be seen as irrelevant to the assessment, but they are better analysed on their own in the relevant section of this submission rather than used for building a hypothetical counterfactual.
84. As to the distribution of the ESOT shareholding to underlying owners, this is an event that would have taken place even absent Ryanair's stake, since its main drivers were tax savings for individuals and elimination of the profit-sharing agreement that Aer Lingus and ESOT entered into at time of the former's IPO. The counterfactual should

therefore also assume that the ESOT shareholding would similarly be dispersed across many different individuals who would not be acting as one block.

7. Ryanair's stake has *direct* competitive significance

85. The stake which Ryanair holds in Aer Lingus provides Ryanair with the means to exercise *direct* influence on the options available to (and therefore the commercial/financial strategies that can be pursued by) Aer Lingus.
86. This direct influence can take two distinct forms: first, it is arguably intended to reduce the attractiveness of Aer Lingus to potential alternative partners, and therefore it is to be understood as part of an ongoing effort to obtain control of Aer Lingus, creating a relevant merger situation. Secondly, it provides Ryanair with an obvious way of exercising material influence on its direct rival Aer Lingus by constraining the decisions of Aer Lingus' management.

Since Ryanair clearly has incentives to reduce the intensity of competition between Aer Lingus and its own operations (as clearly demonstrated by the EC in its 2007 ruling), this ability to directly influence Aer Lingus' behaviour must be seen as potentially anti-competitive. Anticompetitive effects can in turn arise through two distinct channels. In the first place, Ryanair might be able to bias Aer Lingus' commercial strategy to ensure that the two companies compete less closely with each other. In addition, Ryanair might use its shareholdings to systematically oppose Aer Lingus' management, taking up precious managerial resources and hence reducing the efficiency of a direct competitor. As the rest of this section demonstrates, there is evidence that Ryanair has already engaged in both strategies. Moreover, recent and on-going changes in Aer Lingus' ownership structure mean that Ryanair's ability to affect Aer Lingus can only increase over the next few years.

7.1. Stakeholding as part of an ongoing strategy to acquire Aer Lingus

87. Despite its protestations, Ryanair has repeatedly tried to gain control of Aer Lingus for the past six years. Any doubt that Ryanair is still interested in ultimately taking

Irish Independent

O'Leary admits stake in Aer Lingus was 'stupid disaster'

Friday March 06 2009

Ryanair chief executive Michael O'Leary yesterday conceded that his decision to spend €390m of shareholders' money on a stake in Aer Lingus was "stupid". He told journalists that he was "very unlikely" to make another bid for the rival airline and would write his 29pc stake "down to zero" if accounting rules allowed it.

"It was a stupid investment", he added. "At the time, it was the right strategy to go for one combined airline but it [the investment] has now proven to be a disaster"

He added that he'd told shareholders he'd "f***** up" but hadn't apologised.

Aer Lingus over was laid to rest by Ryanair's latest takeover bid. Not only does this raise serious doubts about Ryanair's claim that it has currently no incentives to use its current shareholding to exert influence (since Ryanair is clearly interested in gaining total control); it also suggests that Ryanair's current shareholdings are – and always were – part of its long term unwavering determination to eventually fully acquire Aer Lingus.

88. A minority (but sizeable) shareholding position can support Ryanair's persistent ambition to acquire Aer Lingus by making it harder for another potential bidder to gain control of the company. In addition to making it more likely that Ryanair would win any "bidding war" with another potential acquirer (see the three main mechanisms below), the strategy also helps keep other potential acquirers at bay, while Ryanair bides its time until it can argue that the previous EC prohibition should no longer "hold". In other words, preserving a significant shareholding in spite of the EC's adverse ruling on the merger is clearly aimed at "keeping the target safe" until Ryanair could strike again with a further takeover offer.
89. Further to this, and more generally, minority shareholdings can affect the market for corporate control through three main mechanisms:
- First, shareholders are often divided as to the suitability of outside offers. Given such divisions, a block of almost 30% of outstanding shares is inevitably determinative (or "pivotal") in any decision to accept or reject outside offers.²⁷ Note that this mechanism does not require that the minority shareholder (Ryanair) was itself interested in bidding for the company. On the other hand, there are two further mechanisms which only operate when the shareholder is also one of the bidders.
 - An existing shareholding is generally recognised to confer significant advantages in a bidding context because of asymmetric information. Because of its significant share-ownership, Ryanair undoubtedly paid closer attention to Aer Lingus and had better access to Aer Lingus management than all other potential bidders.²⁸ As abundantly shown in theoretical, empirical and experimental analyses of auctions, the fact that one of the bidder is known to have an informational advantage leads others to bid much more prudently, magnifying the initial information advantage

27 The squeeze-out provisions under Irish company law only apply when a bidder has acquired more than 90% of the shares, so that Ryanair could not be squeezed out by another bidder.

28 Indeed Ryanair has been zealous in ensuring that Aer Lingus respects Ryanair's rights to equality of information with the government, the next largest shareholder, and Aer Lingus has needed to resist its pressure to supply even greater levels of business information.

and making it much more likely that the better informed bidder would win the bidding war – and potentially win it cheaply.²⁹

- A further source of advantage is what the economic literature refers to as the “toehold” advantage of an existing shareholder. The concept is simple: intuitively, the cost of acquiring a company is the cost of purchasing the shares that one does not have. Furthermore, it is easier for an existing shareholder to bid aggressively not only because it needs to pay premium for fewer shares if it wins but also because its bids increase the value of its existing shares where it loses. This, in turn, makes any bidder without shares more prudent, since beating a rival with a significant shareholding (i.e., one that has an advantage for aggressive bidding) is more likely to mean that the bidder is over-paying for the company. The idea that holding shares in a target company helps a potential acquirer of the company fend off rival potential buyers and get the company for a good price is well established. Arguments about “toehold” ownership strategies have long been made in economic analysis, and were explicitly recognised by the CC for instance in the BSKyB/Manchester United case.³⁰
90. Ryanair’s most recent offer for Aer Lingus clearly demonstrates that Ryanair still considers the acquisition of full control at some time in the future as a potential outcome. In this light Ryanair’s current shareholdings should be seen as nothing more than one further piece in Ryanair’s long-term strategy to acquire Aer Lingus. The toehold and asymmetric information arguments are important because *even if one were convinced that Ryanair cannot currently affect Aer Lingus’ strategy directly by active use of its shareholding*, there would still be cause for concern on grounds that the mere existence of the shareholding provides Ryanair with a critically important toehold, that materially reduces the attractiveness of Aer Lingus to potential strategic partners or acquirers.
91. Indeed Ryanair actively promotes the difficulties its minority stake causes for potential airline mergers involving Aer Lingus. For example, when asked by a journalist about the potential for one of the big European flag carriers to take majority ownership and assume management control at Aer Lingus Ryanair CEO replied³¹: *“They are going to have to deal with us and dealing with us is not going to be pretty”*.

29 See, for example Vijay Krishna 2001, *Auction Theory*, Academic Press, pp. 119 – 121 and Paul Klemperer 2004, *Auctions: Theory and Practice*, Princeton University Press.

30 See, for example Huang, M., and Paul Klemperer 1999, “Toeholds and Takeovers”, *Journal of Political Economy*, 107, pp. 427 – 454. See also the CC’s report titled “British Sky Broadcasting Group Plc and Manchester United Plc: A report on the proposed merger” available on http://webarchive.nationalarchives.gov.uk/http://www.competition-commission.org.uk/rep_pub/reports/1999/426sky.htm.

31 Article titled “Takeover cost divides airlines” by Ciaran Hancock on 24 September 2010 issue of Irish Times Business.



7.2. Stakeholding as a way of exercising material influence over Aer Lingus

92. Ryanair's stake in Aer Lingus further provides Ryanair both with the incentive to affect the behaviour of its main rival on several routes, and the ability to do so. Moreover, this ability seems sure to increase in the near future as the structure of Aer Lingus' ownership undergoes changes.

7.2.1. Incentives to influence Aer Lingus

93. The EC motivated its 2007 prohibition of a full acquisition of Aer Lingus by Ryanair on the assessment that, if allowed to acquire Aer Lingus, Ryanair would have had an incentive to increase fares on overlap routes, while minimising the extent of route overlap (i.e., minimising independent competition on the routes flown by Ryanair). This conclusion was subsequently upheld by the General Court in 2010. Ryanair has clearly the same *incentives* in its capacity as a minority shareholder. The only difference between the previously proposed merger and Ryanair's current shareholding position is that a merger would have made it easier for Ryanair to *act* on these incentives.
94. As shown above, the key facts on which the EC based its decision to oppose the 2006 takeover attempt have not materially changed – and certainly not in a way that makes Ryanair's case more attractive from a competition perspective. As the analysis supporting the EC's conclusions still holds, no further discussion of Ryanair's incentives should be required. In practice, Ryanair has the incentive to use whatever influence it might get from its ownership share in order to bias Aer Lingus' actions in a direction that involves softening competition with Ryanair's own operations.

95. As a rival of Aer Lingus, Ryanair also has an incentive to *simply increase its rival's cost of operation*, i.e., decrease Aer Lingus' efficiency and hence decrease the competitive constraint that Aer Lingus exerts on Ryanair. This is distinct from the incentive to "redirect" Aer Lingus' strategy discussed above. Note that this incentive is inversely proportional to size of the stake, because raising a rival's costs likely also implies some loss in the value of that company and hence in the value of the shareholding. This is why this incentive is in fact much more relevant to a situation of minority ownership than to the assessment of a full merger.
96. Ryanair's incentives to influence Aer Lingus and/or raise its costs are in line with its own observed behaviour.³² To date Ryanair has engaged in relentless litigation to stop or delay any requirement to dispose of its shareholding which it has previously indicated was "worthless", and most recently it has launched for the third time an unsolicited bid for Aer Lingus. These actions just cannot be deemed consistent with Ryanair having no interest in exercising a material influence on Aer Lingus' policy.

7.2.2. *Ability to exert influence on Aer Lingus*

97. Ryanair's arguments about not being able to exercise influence on Aer Lingus defy common logic, and run counter to a vast amount of research in the economics and finance literature showing that large shareholders are expected to affect every aspect of a firm's behaviour. There is also direct evidence that Ryanair's behaviour as a shareholder already has influenced Aer Lingus' affairs. Moreover, recent developments strongly suggest that Ryanair's ability to affect how Aer Lingus is run is likely to increase considerably in the near future.

Ryanair keeps trying to exert influence on Aer Lingus

98. Despite its claims of not being able to materially influence Aer Lingus decisions, Ryanair has not stopped *trying* to exert influence by blocking special resolutions, trying to block ordinary resolutions and engaging in extensive lobbying of other Aer Lingus shareholders (e.g., the Irish Government) to this effect. Common sense suggests that a rational agent would not keep trying if there were no chance of success.
99. Examples of Ryanair's attempts to affect Aer Lingus' behaviour include the following.
- i. In 2007, Ryanair opposed Aer Lingus' decision to close the Shannon-Heathrow route in order to use the relevant Heathrow slots for a Belfast-Heathrow service. Ryanair argued that it would have been better for Aer Lingus to redeploy the

³² An example of such behaviour is Ryanair's attempts to interfere with Aer Lingus' lease of Hangar 6 as discussed in paragraph 99(iii).

Gatwick slots used for the Dublin-Gatwick route to establish a Belfast-Gatwick service; or to establish a Belfast-Heathrow service by diverting two Heathrow slots used for Dublin-Heathrow and two Heathrow slots leased out to other airlines. Not only did Ryanair oppose Aer Lingus' management, but it engaged in an intensive lobbying effort to push the Irish Government as a shareholder of Aer Lingus to act in line with Ryanair's position: playing on the loss of local jobs in the Shannon area if Aer Lingus got its way. Note that either of Ryanair's two "alternative proposals" would have resulted in less intense competition between Aer Lingus and Ryanair on London-Dublin routes. In fact Ryanair's CEO betrayed Ryanair's motivation in asking Aer Lingus to maintain the Shannon-Heathrow route as follows³³: "[...] *This need not come at the expense of Belfast, since we believe that Aer Lingus can switch its recently announced 4 times daily Dublin-Gatwick flights to Belfast. Competing from Belfast to Gatwick against the relatively high fare easyJet, will certainly be more profitable for Aer Lingus than competing against the much lower fare Ryanair on the Dublin-Gatwick route. These moves will we believe deliver superior profits and returns for Aer Lingus shareholders and should therefore be endorsed by the management and shareholders of Aer Lingus.*"

RYANAIR RESPONDS TO AER LINGUS CLOSURE OF SHANNON-HEATHROW ROUTE

Ryanair has asked Aer Lingus to call an EGM and we will be asking the trade unions and Bertie Ahern's Government to support this motion calling for Shannon's 4 daily flights to Heathrow to be maintained. This need not come at the expense of Belfast, since we believe that Aer Lingus can switch its recently announced 4 times daily Dublin-Gatwick flights to Belfast. Competing from Belfast to Gatwick against the relatively high fare Easyjet, will certainly be more profitable for Aer Lingus than competing against the much lower fare Ryanair on the Dublin-Gatwick route. These moves will we believe deliver superior profits and returns for Aer Lingus shareholders and should therefore be endorsed by the management and shareholders of Aer Lingus. Alternatively Aer Lingus can still fly four times daily from Belfast to Heathrow by switching one Dublin and one Cork flight and taking back the two Heathrow slots which it presently lease s out.

- ii. In 2009, Ryanair attempted to reduce director and chairman's fees at Aer Lingus. The proposed reductions were drastic, below market rates, and would have severely impacted Aer Lingus' ability to attract appropriate candidates. Directors' fees would have been cut from €45,000 to €17,500 and the chairman's fees would have

³³ Ryanair news release of 14 August 2007 in response to Aer Lingus closure of the Shannon – Heathrow route.

been reduced from €175,000 to €45,000. By contrast non-executive directors at Ryanair were paid €32,000 in 2010.³⁴



- iii. In 2010, Aer Lingus entered into a deal with the Dublin Airport Authority (DAA) whereby it leased Hangar 6 in Dublin Airport following the closure of SR Technics who had previously provided maintenance services to Aer Lingus. The Hangar 6 facility is essential to Aer Lingus' line maintenance³⁵ activities as it is the only hangar at Dublin Airport which can accommodate its A330 aircraft. The leasing of



³⁴ Ryanair Annual Report for 2010 provides only standard non-executive director compensation amounts and does not provide any detail on the Chairman's compensation.

³⁵ Line maintenance generally refers to minor or scheduled maintenance carried out on aircraft.

Hangar 6 also enabled Aer Lingus to significantly reduce its property costs as it was able to move many of its head office functions into Hangar 6 which facilitated the subsequent sale of its Head Office Building and associated site to the DAA. Ryanair publicly opposed this deal, pressuring the Irish Government to convene an EGM at which Ryanair's votes could be used along with the Government's to require Aer Lingus to surrender the lease of Hangar 6 so that it could be leased to Ryanair who would use it to expand in-house maintenance operations for its aircraft.³⁶ In other words, Ryanair tried to use its position as an Aer Lingus shareholder to further its own interests to the detriment of its competitor Aer Lingus.

- iv. In 2010, Ryanair opposed the cancellation of the profit-sharing agreement with the ESOT in return for a one-off payment.³⁷ The cancellation of this agreement allowed ESOT to distribute 6.6 million Aer Lingus shares (approximately 12.5% of the Group's issued share capital) to the underlying owners (4,700 current and former employees of the group). This resulted in significant cost savings for Aer Lingus as it had been servicing the ESOT's debt at a much higher cost than Aer Lingus' own borrowing/deposit rate. The transferred shares now form part of the Group's free float as defined by the Irish Stock Exchange. The level of free float for Aer Lingus has been relatively low after Ryanair soaked up its 30% shareholding which would otherwise have been part of the free float. A higher level of free float not only increased the attractiveness of Aer Lingus for investors but also improved the strategic options available to Aer Lingus' management, as it would make it easier for other airlines to invest in Aer Lingus with a view to forming cementing commercial relationships.

36 In applying pressure on the Irish Government Ryanair focused on the theme that it would have created additional jobs in Ireland should Hangar 6 were sold to it rather than leased to Aer Lingus which was re-locating existing Irish jobs from one site to another.

37 The profit sharing agreement was in place since Aer Lingus IPO in 2006 and was supposed to run until 2018. The cancellation agreement was announced by Aer Lingus on 21 December 2010. On 22 December 2010, Aer Lingus received a letter from Ryanair detailing various objections to the arrangements and seeking the convening of an EGM to enable shareholders to vote in respect of the transaction.



Ryanair can block special resolutions at Aer Lingus

100. Under Irish Law, "special resolutions" must obtain votes of at least 75% of shareholders' voting at a general meeting of the Company in order to be adopted. As a shareholder controlling more than 25%, Ryanair can thus prevent Aer Lingus from passing any special resolution. Those matters that are specifically required under Irish company law to be effected by special resolution include (amongst others):
- a) approving a scheme of arrangement;
 - b) the disapplication of statutory pre-emption rights on allotment;
 - c) the purchase off-market of own shares and shares in holding company, and setting the price of treasury shares;
 - d) alterations of the articles of association; and,
 - e) approval of the proposed terms of a cross border merger.
101. Ryanair has the power (and exercised it in each of 2007, 2008³⁸, 2009, 2010, 2011 and 2012) to prevent the passing of a special resolution for the disapplication of

38 The relevant resolution was withdrawn at the 2008 AGM by the Aer Lingus chairman as Ryanair had lodged a proxy against this and other resolutions meaning that they would inevitably be defeated.

statutory pre-emption rights whereby Aer Lingus would have the option to raise capital without the requirement to offer shares to its existing shareholders first. The blocking of such resolutions means that Ryanair has the power, *inter alia*, to: (i) block future fund raising exercises involving a selective placing of shares for cash, a non-pre-emptive rights issue, or the issue of bonds with warrants convertible into shares; and (ii) impede future acquisitions where an issue of shares for cash is required to raise funds. It should be noted that the special resolution which Ryanair has blocked is not limited to a fund-raising equivalent to 5% of the current share capital of Aer Lingus but would also facilitate a rights issue that could amount to 33% or even 66% of current capital.³⁹

102. A disapplication of the statutory pre-emption rules by way of special resolution is a routine measure of company administration, designed to give management flexibility in its capital raising options, and most listed companies in Ireland (including Ryanair) and the UK have such a resolution in place. Previously in B SkyB/ITV the CC considered the existence of such a veto power in the hands of a direct competitor as giving rise to competition concerns. The inability to raise funds through equity can prevent Aer Lingus from issuing shares in the manner permitted by this resolution to make an acquisition that would increase the competitive constraint it poses to Ryanair.
103. Aer Lingus needs flexibility to be able to pursue a range of equity capital raising options and this is the main rationale for seeking disapplication of pre-emption rights. Seeking an annual disapplication at the AGM saves significant time and cost. Ryanair's blocking of disapplication of pre-emption rights closes off a significant funding avenue to Aer Lingus and places limits on Aer Lingus' ability to actively engage in corporate activity. While Aer Lingus currently has a strong balance sheet (and needs to maintain this strength – see later comments), there are good, practical reasons to augment this strength through access to additional sources of funding. Aer Lingus has, in the past, considered engaging in corporate activity as opportunities arose. This is likely to continue to be the case and it is not unreasonable to expect that Aer Lingus may become involved in M&A activity or corporate asset purchases at some point in the future.
104. If Aer Lingus were to engage in corporate activity, the scale of funding required could potentially greatly diminish current cash reserves if the airline were to fund this activity solely from its own balance sheet. This would leave Aer Lingus in a potentially weakened financial position in the absence of alternative, capital raising options. Historically, aviation sector transactions have typically been “big ticket” deals (e.g., merger of BA and Iberia to form IAG, IAG's recent acquisition of bmi). In

³⁹ See Arthur Cox Memorandum annexed to Aer Lingus' Observations on the OFT Issues Paper dated 3 November 2011 for a detailed review of the rights available under this special resolution.

addition, airlines serving the London market (such as Aer Lingus) periodically seek to acquire additional slot portfolios at London Heathrow. These slot portfolios are typically expensive assets and may involve significant purchase consideration should Aer Lingus ever seek to acquire any slot portfolio which becomes available for purchase. When considering investment opportunities and the use of funds available, and potentially available, to Aer Lingus, the management and the Board must consider the lack of availability of the flexible funding route provided by disapplication of pre-emption rights and the likely additional expense and complication of shareholder approval for such investments including the potential for Ryanair to reject such an approval. Over the longer term this might lead to investment decisions being rejected which could be to the detriment of all shareholders.

105. It is important that Aer Lingus maintains that its current balance sheet strength as the airline must be able to (i) withstand ‘shocks’ such as spikes in the fuel price or the H1 2010 Icelandic volcano and (ii) finance a significant aircraft purchase programme, running several years into the future. In addition, the cyclical nature of the airline industry means that there is may be a need to fund several years of losses in a downturn, before profitability returns. Also, Aer Lingus’ balance sheet strength gives confidence to (i) lessors ahead of significant planned changes to its long haul fleet in coming years as well as to (ii) counterparties on whom the airline relies for fuel and foreign exchange hedging lines - at a time when markets remain tight and Aer Lingus is still a recovering credit story to certain credit market parties. In addition, Aer Lingus has to be careful about the type of debt financing arrangements it enters into. The gearing effect of high airline operational leverage means that airlines’ profits and operating cash flow can be quite volatile. This has implications for both the quantum and type of any debt Aer Lingus can safely incur. For these reasons, additional equity fund raising (as opposed to use of existing cash or debt financing) which can be facilitated through disapplication of pre-emption rights, would be an important alternative financing mechanism for Aer Lingus. It is generally accepted in the UK and Ireland that pre-emption rights are a cornerstone of company law and shareholder approval must be sought before dis-applying the pre-emption right that safeguard shareholders against dilution. However, equally, shareholders understand that there are certain cases where this will be both necessary and acceptable. Also, in many business combinations shares can be offered as part consideration and using the annual disapplication enables these transactions to be executed relatively quickly and effectively without incurring the time and cost of having to seek shareholder approval.
106. The annual disapplication of pre-emption rights is standard procedure for FTSE companies and is borne out by the statistics: amongst the FTSE 350, out of the 289

AGM notices in 2010, 281 companies dis-applied pre-emption rights⁴⁰. Ryanair routinely seeks such approval at its annual general meeting. Ryanair's blocking of this resolution at Aer Lingus' annual general meeting therefore puts Aer Lingus outside of the "norm" for the quoted sector. Finally, it is worth noting the following passage from the Myners report on pre-emption rights:

*"The relationship between directors and shareholders is central to good corporate governance. If there is a lack of trust on either side then problems over the disapplication of pre-emption rights are likely to be only a small subset of a wider malaise. Shareholders appoint boards and if they do not have faith in the judgement of those that they have appointed, then the problem needs to be tackled head-on. Refusing to dis-apply pre-emption rights is not the right response".*⁴¹

107. Furthermore, the ability to selectively place shares helps forming alliances between airlines that are based on minority shareholding arrangements. A recent example on this was the cross shareholdings which Iberia and BA held in each other prior to their subsequent merger. Ryanair's vetoing of resolutions for disapplication of pre-emption rights exclude such options from the range of alliance opportunities Aer Lingus can pursue.
108. A potential partner in an alliance based on cross-shareholdings may wish to have an exit arrangement which would allow its shares to be bought back or redeemed for cash at a fair market value if the alliance were to be terminated. Ryanair could block such arrangements.
109. All of the above suggests that the ability of Ryanair to block special resolutions gives it considerable control over Aer Lingus strategic options relating to forming alliances with other airlines.
110. Schemes of arrangement and cross border mergers are mechanisms publicly listed companies such as Aer Lingus can use to merge with others. Both allow the bidder to save 1% stamp cost on the offer price and also provide more certainty on the timing of the change of control as the bidder will know that 100% of control can be obtained within 2 days of the court approval.⁴² Ryanair's ability to block special resolutions also reduces the potential merger options that could be pursued by Aer Lingus.

40 Source: PLC What's Market.

41 See Study by Paul Myners on the impact of shareholders' pre-emption rights on a public company's ability to raise new capital, p7. Full report available at <http://www.bis.gov.uk/files/file28436.pdf>.

42 In a conventional takeover offer, the bidder must first get acceptances from 90% of the target company's shareholders before it can initiate a compulsory acquisition procedure which can take several weeks to complete and which has no guarantee of 100% of control at the end of the process.

111. Ryanair has argued that the ability to block such resolutions does not confer much control over the company. This claim seems inconsistent both with the observed structure of shareholdings and Ryanair's own behaviour.
112. It is revealing that the Irish Government made sure to retain an ownership share (25.1%) that just exceeds the threshold that makes it possible to block special resolutions unilaterally. We do not believe that this is a coincidence. Traditionally when States divest strategic companies that were formerly state-owned, they make sure to retain a measure of influence. That the Irish Republic chose to retain 25.1% of those shares indicate that they actually believe that the ability to block special resolutions confers non-negligible influence. It is also relevant that Ryanair itself made sure to acquire shares in excess of the 25% threshold.
113. We also note that, apart from blocking special resolutions relating to dis-application of pre-emption rights for six years in a row, Ryanair has also opposed the following special resolutions:
- i. At the 2008 annual general meeting ("AGM") the special resolutions regarding purchasing of company shares and the reissue price range for treasury shares;
 - ii. At the 2010 AGM, a special resolution that would have approved changes to the Aer Lingus Articles of Association reflecting the implementation of the Shareholders Rights Directive.
114. With the exception of the 2008 AGM, where the propositions were withdrawn in the face of Ryanair's opposition,⁴³ we have a record of votes on the special resolutions that Ryanair decided to veto. The resolutions relative to the waiving of pre-emption rights were opposed by 31.8% of the vote in 2007, 37% in 2009, 38.7% in 2010, 43% in 2011 and 41.6% in 2012, while the resolution about the Articles of Association was rejected in 2010 with 38.7% of the votes cast against. In all cases then, Ryanair was determinant in the sense that the special resolutions would have passed but for Ryanair's opposition.
115. Ryanair's ability to block special resolutions – let alone the fact that Ryanair *did* block some special resolutions - demonstrates not only that Ryanair can exert material influence on Aer Lingus, but also that it can do so in areas that are important to Aer Lingus' competitiveness – and hence on the competitive constraint that Aer Lingus imposes on Ryanair. The cost, level and structure of Aer Lingus' financing will inevitably affect Aer Lingus' operating and investment costs and hence its market behaviour. Therefore by affecting these aspects of Aer Lingus' financing Ryanair impacts Aer Lingus commercial behaviour.

43 In this instance Ryanair had lodged a proxy against each of the resolutions ensuring that they would be defeated put to vote.

116. The strictures imposed by Ryanair are not innocuous. Many public companies routinely use waiver of pre-emption rights to allow the management to react quickly to market opportunities e.g., implementing potential acquisitions. We note that Ryanair itself has passed such a waiver of pre-emption rights in 2011. Share repurchases can be used by the management to signal undervaluation of the company in the market. Ryanair has used such buyback programs on a number of occasions in recent years. The simple facts are therefore that Ryanair has used its veto power over special resolutions to prevent its rival from accessing financial tools that it has used itself.

Ryanair can be determinative for the approval or rejection of ordinary resolutions

117. A substantial minority shareholder can also affect ordinary resolutions (i.e., those only requiring 50% of the votes for approval). With a large enough stake, a minority shareholder may become *pivotal*. This occurs whenever the approval or rejection of a resolution is determined by the position of the minority shareholder (i.e., where the outcome of the resolution would have been reversed, had the minority shareholder changed sides). For example if a given motion carries with 70% of the votes and was supported by a 30% minority shareholder, this shareholder is pivotal since withdrawing its support to vote against the proposal results in the proposal being defeated. This effect is compounded by at least two factors: diversity of opinion and voter turnout.
118. Diversity of opinion among shareholders is indeed what allows a minority shareholder to become pivotal. At the extremes and using the example above, if all other voters agree (i.e., 70% of remaining shareholders all vote together), a resolution will pass/fail regardless of the minority shareholder's position. However, if conversely the remaining shareholders' positions are divided equally (i.e., 35% in favour, 35% opposed to a resolution), the minority shareholder is pivotal, and its vote will decide the matter. From a practical standpoint, the greater number of shareholders, the greater the chance of a diversity of opinion. And the greater the diversity of opinion, the greater the role of the minority shareholder.
119. Limited voter turnout at shareholder meetings also increases the effective voting power of an active minority shareholder, making it even more powerful. As voter turnout declines, a large minority shareholder needs fewer and fewer additional votes to decide the outcome (or less and less diversity). If turnout is low enough, it may actually command an absolute majority at a given general meeting or for a specific resolution.

Ryanair as the pivotal voter

120. Ryanair's power as a minority shareholder is increased for both of the above reasons. Diversity of opinion is present with few large voting blocks. After the Irish Government, no other shareholder holds more than 4%.⁴⁴ And in fact, many of the "larger" shareholdings in Aer Lingus are held by nominee accounts where the nominee acts in an execution capacity only. An analysis of the voting patterns of these nominee accounts confirms that a given nominee does not always vote its shares as a block. In some cases, the nominee may not receive instructions on how to vote all the shares held by it, resulting in (some of) those shares not being voted. A nominee may also receive different voting instructions from different shareholders with the result that shares in its block are not voted uniformly.
121. The ESOT shareholding is also no longer there to provide some measure of a counterweight to Ryanair's influence. Since December 2010, almost all of the shares previously held by the ESOT have been distributed to its beneficiaries: the majority in December 2010, with subsequent distributions in June, July, and September 2011. In that time, ESOT's shareholding has declined from 12.47% of issued share capital (66,577,980 shares) to 0.04% of issued share capital (228,022 shares).
122. On top of all of this, shareholder voter turnout has also declined since December 2010, both with respect to the shares previously held by ESOT and to total issued share capital. At the 2010 AGM (and those prior), all shares held by ESOT were voted, amounting to 12.47% of issued capital; whereas at the 2012 AGM, votes of the beneficiaries to whom the ESOT shares were distributed accounted for only 0.45% of issued share capital. Likewise, and not surprising given the reduced participation of beneficiaries to whom the ESOT shares were distributed, at the 2010 AGM approximately 77.6% of total issued share capital was voted; whereas at the 2012 AGM, total turnout ranged from 72% (Resolution 1) down to 68% (Resolution 10, which was conducted by poll). Accordingly, Ryanair's 29.82% shareholding carries even greater weight in a general meeting with the reduced turnout since the dispersal of the ESOT shareholding.
123. Based on a voter turnout of 72%, Ryanair's effective voting power is increased to 41%⁴⁵. To reach 50% it therefore only needs an additional 9% of votes cast.⁴⁶ But

44 In fact, the Irish government has indicated its intention to sell its 25.1% holding in Aer Lingus. The timing and process for the sale have not been determined, but this prospect puts added significance on Ryanair's 29.8% holding. If the 25.1% is not sold as a single block, it will greatly increase Ryanair's ability to determine the outcome of general resolutions as the only large minority shareholder. See further at para 164.

45 $72\% * 29.82\% = 41.4\%$.

more importantly, to go against Ryanair, 91% of the other shareholders present need to agree. As the number of shareholders and diversity of opinion increase, this becomes increasingly less likely.⁴⁷

124. Ryanair's ability to affect Aer Lingus' behaviour of course comes as no surprise. There is a large economics and finance literature that explores the relationship between shareholder control and the performance of corporations. The general idea is that unsupervised managers would take advantage of their freedom to pursue their own objectives which are not in line with optimising the firm's performance to the benefit of all shareholders. Of course, shareholders can in principle monitor the actions of the managers. But monitoring is costly so small shareholders have no reason to incur such costs to do a job that benefits all shareholders. This is why the presence of large shareholders is likely to be associated with closer supervision of managerial activities. This closer supervision might be used to improve the performance of the firm or to collude with managers to divert surplus away from smaller shareholders.⁴⁸
125. The specific mechanism does not matter for our purpose. What matters is that this whole body of analysis rests on the notion that large shareholders *do* affect the behaviour of the corporations in which they have a stake. Importantly, this literature has also empirically estimated the relationship between various indicators of firm performance and the concentration of share-ownership. Almost every study in the field finds that there is indeed a significant relationship between firm performance and ownership concentration. Moreover, studies that pay special attention to the existence of large minority shareholders find that they unerringly affect the behaviour of the firm. It should be noted that in those studies a "large" shareholder is usually defined as one who holds *at least 5%* of the outstanding equity. No single study has found that

46 This 9% figure is the percentage of voters present. As a percentage of all shareholders (i.e., including those that did not turn out for the general meeting), it is accordingly lower: 6.5%. It bears mentioning here that approximately 4% of all shareholders are cross-shareholders, holding shares in *both* Ryanair and Aer Lingus. Presumably some at least of these cross-shareholders' interests are aligned with those of Ryanair's and they would vote accordingly. This effectively boosts Ryanair's voting power further, bringing it closer to being able to pass resolutions on its own. Including these cross-shareholders with Ryanair's shareholding (i.e., 29.82% + 4%), Ryanair's effective voting power would exceed 50% and allow it to pass resolutions on its own when voter turnout declines below 67.64% (i.e., 33.82% * 67.64% = 50%). For one resolution in 2012, voter turnout was 68%.

47 Aer Lingus has resorted to a proxy solicitation firm in an attempt to increase voter turnout; however, even with such support, 2012 AGM turnout was only 72%.

48 See, for example C.G. Holderness, 2003, "A Survey of Block-holders and Corporate Control" *Economic Policy Review*, pp. 50 – 65.

- an agent holding as much as 30% of a firm's stock had no effect on that firm's behaviour.^{49 50}
126. Ryanair's role as a pivotal voter who can influence the outcome of ordinary resolutions in Aer Lingus provides Ryanair with the ability to affect key decisions by Aer Lingus management. As a public limited company, substantial commercial transactions may require shareholder approval by ordinary resolution.⁵¹
127. One matter which is highly critical at this very moment relates to Ryanair's efforts to frustrate Aer Lingus' resolution of its pensions issues.⁵² The need for resolution of these issues has reached a critical stage. Growing concerns among investors about the scale of potential liabilities are exerting a downward pressure on the share price and concerns among staff are a potential source of industrial unrest. Trade unions are currently balloting their members to authorize industrial action in the event that Aer Lingus does not address the funding shortfall.
128. As can be seen from the related correspondence (available in the OFT's files), Ryanair has waged an ongoing campaign against Aer Lingus and its directors to prevent any further payments being made without shareholder approval (even if such approval is not required under Irish company law). Ryanair has threatened legal action to force Aer Lingus to obtain shareholder approval and has indicated that it will use its shareholding to prevent any such additional payments. Ryanair has also sought to influence other shareholders to oppose any further payments and will undoubtedly exploit genuine concerns among institutional shareholders on this issue.
129. [CONFIDENTIAL]

49 Studies of the impact of large minority shareholders of course focus on companies where no other stakeholder has more than a 50% share.

50 For instance Zeckhauser and Pound who choose a threshold of 15 % justify their choice as follows: *"15% appears to verge on an ownership level that many analysts construe to have serious control implications. For example, many states have recently passed so called control share acquisition provision, which stipulate that shareholders passing a 20% ownership threshold are considered to have a clear control intent."* (page 166).

51 Transactions which constitute Class 1 transactions under the Listing Rules require shareholder approval by ordinary resolution. For example, shareholder approval was required in April 2008 in relation to the purchase by Aer Lingus of 12 longhaul aircraft. As discussed in **Annex 1**, Ryanair lodged a proxy against this motion, though it was ultimately passed.

52 [CONFIDENTIAL]

OPEN LETTER TO ALL AER LINGUS SHAREHOLDERS**Re: Aer Lingus' Defined Contribution Pension Schemes**

Dear Shareholder,

Since Aer Lingus has refused to facilitate Ryanair's EGM requisition, and since Ryanair has failed to elicit any statement from the Board of Aer Lingus that no further contributions will be made over and above its current fixed contribution rate of 6.375%, Ryanair intends to initiate legal proceedings to prevent the company agreeing to, or making, any such additional contributions without prior shareholder approval.

I am writing to make you aware of these developments and also request that you as a shareholder of Aer Lingus would communicate your views on these matters directly to Ryanair (as required by the Rules of the Superior Courts), and/or to the Board of Aer Lingus, since otherwise we fear that shareholder funds will be frittered away by Aer Lingus (via further unnecessary contributions to its defined contribution pension scheme) at shareholders expense, as Aer Lingus has recently when it gifted some €27m to the ESOT to allow it to repay its bank debts, and then wrote a cheque for some €30m to the Irish Revenue to pay off tax liabilities of individual employees who benefited under Aer Lingus' failed leave & rehire scheme.

Yours sincerely,

Michael O'Leary
Chief Executive

Ability to influence route network through blocking disposal of Heathrow slots

130. Aer Lingus' Articles of Associations contain provisions that effectively give Ryanair veto power on the disposals of the company's valuable Heathrow slots. Those clauses were introduced at the time of the IPO to lend some standing to the government in relation to any initiative to "empty" the company of these precious assets. According to the Articles, Aer Lingus must notify its shareholders if it wishes to dispose of any of the Heathrow slots which it held at the time of its IPO in 2006 (subject certain limited exceptions). Shareholders representing at least 20% of the issued share capital can then require that an EGM be convened to vote on the proposed disposal. At this EGM, the number of votes required to approve a slot disposal is set by reference to the level of shareholding held by the Minister for Finance at the time of the AGM. The Articles provide that the disposal may only proceed if the relevant resolution is passed by:
- no less than X% of the votes cast, where "X" is equal to 100 minus the ratio of ordinary shares held by the Minister for Finance to total issued shares expressed as a percentage plus 5%, i.e., $X = 100 - (\text{shareholding by Minister for Finance} + 5)$

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- It is further provided that required majority approve a disposal should in no event exceed 75%.
131. This rule has the effect that, as long the Minister for Finance holds a share of at least 20%, he can successfully oppose a slot-disposal proposal as long as at least 5% of shareholders agree with the Minister or if all voting shareholders disagree with the Minister but 20% of shareholders do not participate in voting. It of course also grants the same power to any shareholder with a stake at least as large as the Minister's.
132. Applying this formula to the current level of shareholding of the Minister (25.11%), the percentage of votes cast which would be required to approve a slot disposal would be 69.89% [i.e., 100% - (25.11%+5%)]. Given that Ryanair currently has a shareholding of 29.82% it can veto any resolution on the disposal of Heathrow slots as long as at least 0.29% of shareholders do not participate in the EGM and/or side with Ryanair. Given historical levels of participation at EGMs, this implies that Ryanair can in fact unilaterally block any such proposition: on receiving notification of slot disposal Ryanair has sufficient shareholding to require an EGM to vote on the disposal, and it can then be sure to prevail at this EGM.
133. The Heathrow slots held by Aer Lingus are a major asset. It has been reported that “[d]eals at £5 million to £20 million (\$10-40 million) a pair have hit the headlines recently, while there is also talk of still higher prices in some quarters.”⁵³ Aer Lingus is the fourth largest slot holder at Heathrow Airport and its slot portfolio is likely to be worth in excess of €250 million. Ryanair's ability to block the disposal of any number of Heathrow slots that it can prevent Aer Lingus from pursuing opportunities to enlarge its network by unlocking some of the value in its Heathrow slots.
134. There are two ways in which Aer Lingus could make use of its capital in the Heathrow slots to finance its commercial strategy. First, Aer Lingus could obtain debt secured against these slots at a lower cost than unsecured debt.⁵⁴ However, given Ryanair's ability block disposal of slots, financial institutions would be unlikely to accept the slots as collateral. Secondly, the slots could be sold or they could be exchanged with another airline for slots at other airports where Aer Lingus seeks to expand its operations. If Ryanair considers that a sale or exchange of Heathrow slots would likely lead to stronger competition for Ryanair's own operation at another airport, it would have an incentive to block such sale or exchange and would have the ability to do so.

53 <http://www.flightglobal.com/news/articles/slot-trading-at-heathrow-216996/>.

54 BA for example, is launching its first bond sale backed by slots at Heathrow. See IAG News Release dated 9 July 2012. Available at <http://www.iairgroup.com/phoenix.zhtml?c=240949&p=irol-newsArticle&ID=1712478&highlight=>.

135. [CONFIDENTIAL]

Ryanair's constant activism consumes scarce managerial resources

136. We have already mentioned a number of examples where Ryanair has tried to oppose the policies of Aer Lingus' management. Some examples concerned special resolutions requiring a 75% majority for approval, while others – such as Ryanair's opposition to the purchase of aircraft or the reallocation of assets away from Shannon – related to ordinary resolutions. Ryanair was successful with the first type but not with the second type. We have shown however that, in the near future, Ryanair would be much more likely to be able to block some ordinary resolutions as well. Still, for argument's sake, let us assume for the moment that Ryanair can only be successful in the context of special resolutions. It remains that, over the last five years, Ryanair has expended considerable effort to oppose Aer Lingus' management on a large number of issues. As discussed above a full list of such episodes can be found in **Annex 1**.
137. This behaviour has often involved Ryanair making complaints to various regulatory bodies in Ireland and the UK, alleging and threatening Aer Lingus directors with personal liability. None of these complaints have been upheld but have nevertheless caused Aer Lingus to devote significant resources and incur substantial costs in connection with the resulting investigations.
138. It should also be noted that Ryanair has used its minority shareholding to attempt to obtain commercially sensitive information from Aer Lingus. Specifically, in March 2011, Ryanair presented Aer Lingus with a series of questions, a number of which relating to commercially sensitive issues such as predicted yields and revenue, and Aer Lingus' intentions regarding fuel surcharges. The Group will be aware that BA and Virgin were subject to significant fines, and senior management of BA were subject to criminal prosecution, in respect of collusion on fuel charges.

Revenues

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- 10 In 2011 does management expect yields to rise or/fall on Short and Longhaul routes?
- 11 Does management plan to increase Longhaul fuel surcharges. Will shorthaul continue to be surcharge free?
- 12 Will Ancillary revenue per passenger rise or fall in 2011?
- 13 What do management expect will be the key drivers in ancillary revenues in 2011?
- 14 Was the cargo business Profitable on a fully recovered basis in 2010. What about 2011?

139. These examples – and those included in the broader list – raise two issues. Firstly, some of the disputes clearly concern aspects of Aer Lingus’ management that would be of direct relevance to a close competitor like Ryanair. Secondly, *even if the disputes were unrelated to any aspect of management that is directly relevant to its competitive stance*, it remains that facing and resolving those disputes is both disruptive and time-consuming for Aer Lingus management and often involves very significant costs due to the requirement for legal and financial advice. By repeatedly opposing Aer Lingus management on a number of issues and pursuing some of these through complaints to regulators, court proceedings, and significant lobbying campaigns, Ryanair clearly raises the management costs of Aer Lingus and prevents senior management from giving their full attention to the design and implementation of Aer Lingus’ commercial strategy. Strategies aimed at raising rivals’ costs are widely considered as anticompetitive even where such strategies have not ultimately succeeded. The fact that Ryanair uses its stake in Aer Lingus to pursue such a strategy is therefore one more reason why Ryanair should be required to divest its holding.
140. Finally, the CC should have regard to the impact on Aer Lingus management of the various takeover bids which Ryanair has mounted since Aer Lingus’ IPO, including the most recent one. We are not aware of any other company which has been subject to so many bids in such a short period of time particularly where a recent bid has been subject to an antitrust prohibition decision. In addition to the enormous costs and drain on resources which inevitably have resulted from the repeated bids, the obligations placed on Aer Lingus during the bid periods under the Irish Takeover Rules relating to frustrating action impose a very significant burden and may restrict its commercial freedom. Specifically, Aer Lingus is required to obtain consent from the Takeover Panel for significant contracts and in some cases may be required to obtain shareholder approval. Indeed in the short period which has elapsed since the most recent bid, Aer Lingus has had to seek approval from the Takeover Panel in respect of six separate transactions. The use by Ryanair of its minority shareholding as a platform to launch repeated bids for control of its closest competitor (regardless of their prospects of success) should also be viewed as a tactic to distract management and consume valuable resources.

8. Effects of Ryanair's having rights to Aer Lingus' profit streams on Ryanair's own behaviour

141. Ryanair's stake can also harm competition through the effects that holding even a partial right to Aer Lingus' profit stream creates on Ryanair's own incentives to compete. As the OFT decision most recently explores, given the importance of the competition between the two airlines for passengers on routes between the UK and Ireland, such lessening of competition can have material adverse consequences for consumers.

8.1. An illustration of the potential competitive effect of a minority stake

142. To understand why partial ownership of a rival matters, it is useful to start from the example of a full merger between two competing firms, A and B. Suppose first that both firms are owned and operated independently. When considering whether or not to cut its price, firm A weighs the extra sales that such a price cut would generate against the fact that all sales are now made at a lower unit price. Of course, a decrease in A's price would also hurt the profits of firm B (because it may induce some of B's customers to switch to A), but this is not a consideration that enters into the computations of firm A.

143. Assume now that firm A buys firm B (in a full merger), but retains the two pre-merger product lines A and B. When deciding whether or not to decrease the price of A, the merged entity now also takes into account that this would decrease the profits made on product line B – as the profits from both product lines form part of its overall profits. Accordingly, decreasing the price of A is less attractive than before the merger and in the absence of any merger-specific efficiency, the merger leads to a higher price for A.

144. In more detail, Ryanair's minority ownership in Aer Lingus of course differs from the simple benchmarks above in two respects: first, the cross-share ownership is asymmetric, i.e., Ryanair owns a stake in Aer Lingus but Aer Lingus does not own a share in Ryanair; secondly, Ryanair owns only about 30% of Aer Lingus' shares and is therefore only entitled to 30% of Aer Lingus' profits (as opposed to the full profit stream). Because of the asymmetry, Ryanair's stake's in Aer Lingus does not affect Aer Lingus' own incentives: it should still choose fares and other key variables to maximise the profits from its own operations, and ignore any deleterious effects on Ryanair. The position is different for Ryanair: because cutting its price hurts its rival's profits, any given cut would be objectively less attractive to Ryanair if it holds some Aer Lingus shares, than if it does not. Thus Ryanair's investment in Aer Lingus *decreases* Ryanair's unilateral incentives to compete with Aer Lingus, i.e., to cut fares to attract passengers away from Aer Lingus.

145. To illustrate the order of magnitude of the effect from partial financial interest compared to the expected effect of a full merger, it is useful to provide a simple

example. We will then turn to methodologies that make it possible to gauge the likely effect of the minority shareholding in the specific case at hand. For illustration purposes only, consider a case where N identical firms compete in a given market, selling identical products that can all be produced at a constant unit cost. Calculations are straightforward and shown in the [Annex 2](#). The table below compares the decrease in output associated with a full merger for various values of N (second column) with the decrease in output associated with a situation where one firm owns minority share of 30% in another firm (third column).

Table 2: Decrease in output arising from a minority share, compared to full merger

Number of Firms	Decrease in Output Due to Full Merger [1]	Decrease in Output Due to Minority Ownership of 30% [2]	[2] / [1]
2	0.167	0.0625	37.4%
3	0.085	0.023	27.1%
4	0.05	0.014	28.6%
5	0.03	0.0098	32.8%

146. The third column is the ratio between columns three and two multiplied by 100, i.e., it gives the decrease in output due to the 30% minority ownership as a percentage of the decrease in output due to a full merger. We see that in spite of the fact that the partial ownership is asymmetric (i.e., only one firm owns a share in another) a 30% minority ownership creates a negative output effect roughly equal to 30% of the effect that would be expected from a full merger. The effect is therefore sizeable when the markets are highly concentrated, which is the case for UK-Ireland routes.

8.2. Price pressure indices suggest upward pressure on fares

147. A more specific sense for what might be the effects of Ryanair's stake in Aer Lingus on Ryanair's pricing incentives may be obtained from "price pressure indices".
148. As explained more fully in [Annex 2](#), "upward price pressure" indices are a way of combining information on closeness of competition and the gross margin to generate some idea of what the incentives for price increases resulting from a merger might be. One common such index is the so-called "GUPPI" ("gross upward price pressure index"). Generally competition authorities consider that a GUPPI of more than 10% is problematic, and GUPPI value between 5% and 10% is still worth investigating further. The GUPPI approach can also be readily adapted to gauge the effect of minority ownership, to capture the idea that if a firm owns only part of another firm's shares, it recovers only part of the benefits of any price increase on a rival in which it holds a stake.

149. For a number of O/D pairs Ryanair and Aer Lingus are the only airlines providing direct flights. On such routes, it is very likely that a substantial proportion of passengers who would leave Ryanair following a fare increase would fly instead with Aer Lingus. It seems therefore reasonable to assume that for routes on which they are the only competitors providing direct flights, close to 100% of passengers switching away from Ryanair would switch to Aer Lingus (and vice versa). Alternatively if we were to consider a broader “Ireland to UK market”, where the two airlines have a joint market share of about 80%, it would seem reasonable to assume that the proportion of travellers that Ryanair would lose following a fare hike who would switch to Aer Lingus would be in excess of 60%.
150. The other relevant element for a GUPPI-type calculation is the gross profit margin a rival brand would earn from increased sales. The marginal profit Aer Lingus makes from selling more tickets on its existing flights due to some passengers diverting from Ryanair is likely to be significant. Where Aer Lingus can accommodate an additional passenger (switching from Ryanair) on an existing flight the increase in its costs due to carrying this additional passenger is typically minimal (as few cost items for that flight would change).
151. As again shown in the **Annex 2**, if Aer Lingus’ gross profit margin were above 30%, then even if the likely “diversion” from Ryanair to Aer Lingus was only 60% (a conservative value for routes between UK and Ireland where the two airlines are the only ones offering direct flights), then Ryanair’s shareholding of 29.82% would imply a GUPPI well above 5%. For other realistic combinations of margins and diversion ratios the effect would be larger, and in excess of 10%. The possibility that Ryanair’s shareholding in Aer Lingus might give rise to an SLC on at least some routes between the UK and Ireland, as a result of its impact on Ryanair’s incentives to raise fares, is therefore very real also on this measure.

9. Importance of a forward-looking assessment, and limited insights from route pricing studies

9.1. Key criteria for the assessment are incentives and ability to act in future

152. As explained, Ryanair has both the incentives and the means to influence the behaviour of its closest rival for traffic between Ireland and the UK. Taken as a whole, economic logic and the available evidence present a single consistent picture: that Ryanair has indeed manifestly and systematically sought to affect Aer Lingus' behaviour. Absent remedial action which removes either the incentive or ability of Ryanair to do so, there is no reason to expect Ryanair would spend less effort in trying to affect Aer Lingus policy. Moreover, one should expect Ryanair's efforts to result in increasing actual influence on Aer Lingus as Ryanair's shareholder power has been considerably magnified by recent changes in the ownership of the rest of Aer Lingus' outstanding shares and may be further strengthened following the sale by the Irish Government of its shareholding.

153. Ryanair's past actions on their own demonstrate that concerns about its shareholding in Aer Lingus are not overblown abstract constructs, but very real. Crucially, such concerns would remain valid even if Ryanair had not actually succeeded in influencing Aer Lingus' behaviour or even if Ryanair had not tried to do so in the last five years. In the presence of incentives and ability to act in an anticompetitive manner, competition rules are not suspended for "good behaviour". By its nature merger control is a forward looking process. There is no reason to consider a different standard when assessing the competitive effects from a minority shareholding. Indeed, this was the view conveyed by the CC in BSKyB/ITV where paragraph 3.65 of the decision noted:

"[...] the test that we have to apply in deciding whether a relevant merger situation had been created is whether the ability to exert material influence has arisen, not whether, in practice, that ability has been exploited"

154. Aer Lingus therefore believes that the CC's review should focus on Ryanair's incentives and ability to exert material influence on Aer Lingus, without devoting undue effort to prove the actual effects of such interference through empirical analyses of market data. Thus while this submission has clearly shown that Ryanair *has consistently and repeatedly* sought to influence Aer Lingus and might well have had an effect on its commercial conduct, whether or not Ryanair actually influenced Aer Lingus' behaviour over the last five years cannot ultimately be the relevant test. In this sense, Ryanair's repeated attempts to affect Aer Lingus' conduct are the most relevant evidence, because they constitute the clearest evidence that Ryanair has an incentive to interfere. They also constitute important evidence of Ryanair's ability to exert influence as it would not keep engaging in this type of behaviour despite incurring costs from it if it believed that it was always bound to fail.

9.2. Limited insights from empirical pricing studies

155. Aer Lingus understands that econometric analyses have been submitted by Ryanair to the OFT, purporting to show no evidence that its stake in Aer Lingus induces Ryanair to soften competition and charge higher fares. While Aer Lingus has not seen these analyses, it assumes that the evidence sought to compare changes in fares between the period preceding Ryanair's acquisition of the stake and the period following this acquisition, both for routes where Aer Lingus and Ryanair overlap and for routes where they do not. The basic idea could be that, if Ryanair had actually softened competition on the overlap routes, its fares on such routes would have increased more (or decreased less) than fares on other routes.
156. These studies should not distract the CC. As explained in this submission, the key criteria for assessing whether or not Ryanair's minority stake in Aer Lingus should be seen as anticompetitive are incentives and ability, not effect. There should therefore be little need for this type of extensive econometric analysis of historical pricing.⁵⁵
157. Moreover, there are several reasons why, in the context of this investigation, econometric analysis of route pricing is unlikely to be informative:
- a. First, even if one was to find no systematic difference between overlap and non-overlap routes, this does not tell us much. As already noted by the OFT, over the last five years Ryanair remained under scrutiny by competition authorities so one cannot assume that its pricing behaviour over this period is representative of what it would be once such scrutiny has lapsed.
 - b. Secondly, the last five years have been a period of great economic turmoil. Trying to identify significant effects on a few routes over such a relatively short and troubled period is like looking for a needle in the haystack: the surprise would be if one *would* find any significant effect. Thus *not finding* that prices on overlap routes have changed in a manner that is significantly different from the behaviour of fares on other routes is a very weak test that cannot be seen as necessary to establish a presumption that there has been harm to competition.
 - c. Thirdly, even if a negative result could be considered convincing evidence that fares were not significantly higher on overlap routes, this would only address some of the channels through which Ryanair might have had a material impact on Aer Lingus and hence on competition. For example, such empirical evidence is totally unrelated to Ryanair's ability (and incentives) to weaken Aer Lingus *directly* by interfering with decisions such as airplane purchases or

55 In merger analysis such studies are used in the context of a forward looking assessment. In particular, they are used to assess the degree of competitive constraints the firms are able to offer each other when acting independently so as to gauge the increase in market power and the resulting price increase that is expected due to the merger. In those analyses, it is assumed by definition that in its pricing the merged firm will make use of any additional market power due to the merger: whether or not prior to the merger a firm was exploiting its then existing market power in full is not a relevant consideration.

by generally increasing Aer Lingus' management costs. Such "raising rival costs" interference would handicap Aer Lingus across the board, not just on the routes that it shares with Ryanair. A comparison of fare changes between overlap and non-overlap routes cannot therefore possibly capture the possible effects of this type of interference.

- d. Fourthly, a comparison of fare evolution between overlap and non-overlap routes would also fail to capture any effect on entry and exit decisions. There are two parts to this issue. To begin with, Ryanair's shareholder activism might affect Aer Lingus' own entry and exit decision. In addition, as explained above, Ryanair might itself decide not to serve routes that would be only marginally profitable in order not to unduly decrease the value of its stake in Aer Lingus. Such behaviour would imply that, compared to a counterfactual without Ryanair's stake, fares on some routes where Aer Lingus and Ryanair *do not* overlap would be higher, precisely because Ryanair's stake has affected the parties' incentives to both operate on these routes. In the context of the empirical work presented by Ryanair this type of strategic avoidance of head to head competition would actually reduce the difference between changes in fares on overlap and non-overlap routes, i.e., the more such strategic avoidance there is, the more likely it is that Ryanair's empirical work would find no effect from Ryanair's minority shareholdings. This point is especially important given that Ryanair does not currently control Aer Lingus' fare-setting policy. Whatever influence it might have been able to exert so far relates more to general financing costs, investment decisions, and decisions about the redeployment of assets on routes. This means that there are in fact few reasons (besides Ryanair's own unilateral incentive to possibly soften competition) to even *expect* that most of the impact from the minority shareholding would take the form of difference in fares between overlap and non-overlap routes.
- e. The type of empirical work proposed by Ryanair also fails to capture the effects of Ryanair's shareholding on other parties' incentives to invest in Aer Lingus (or even take control of Aer Lingus).
- f. Since the EC's prohibition decision, Aer Lingus management has been actively and consistently pursuing the forced sale by Ryanair of its minority shareholding. Should the current CC investigation not result in a disposal of Ryanair's shares, Aer Lingus will be faced with a situation where Ryanair will be able to remain on its share register indefinitely and will be in a position to launch further takeover bids at times of its choosing. [CONFIDENTIAL]
- g. Finally, and most importantly, an empirical analysis, however fancy, cannot capture the likely effect of the sharp increase in control that Ryanair is likely to benefit from following the recent dispersal of the ESOT block, quite aside from changes potentially ahead regarding the government shareholding.

158. For all of these reasons, it would thus be wasteful for the CC to expend significant time and resources in seeking to verify empirically whether Ryanair's shareholding in Aer Lingus has had the effect of perceptibly raising Ryanair's fares.

10. Aer Lingus: the past and the future

159. While merger control is generally prospective, the Inquiry Group has the unique opportunity to look back over some six years of distraction and disruption by Ryanair. For the reasons given above and as comprehensively set out by the OFT in its reference decision, there can be no doubt that Ryanair's shareholding gives it the ability to exercise material influence over its competitor, and that this has resulted in an SLC: and will, unless remedied, continue to do so. The evidence of this period also confirms that Ryanair has the *incentive* to harm its competitor Aer Lingus. Ryanair's ability to act on its incentives has given rise to an SLC, to the detriment of UK consumers, which will persist unless remedied. Indeed, given the consistent level of interference by Ryanair, despite its minority shareholding being subject to potential antitrust scrutiny, one can only speculate how it would behave should it transpire that its shareholding is immune from review.
160. Starting almost immediately after the failure of the first bid, from the summer of 2007, Ryanair has sought to fetter Aer Lingus as its principal competitor. The shareholding provides Ryanair with the means to harm competition both directly, by weakening Aer Lingus as a competitor, and indirectly, as Ryanair also benefits from softening competition with Aer Lingus.
161. The direct competitive significance of Ryanair's shareholding is illustrated by the fact that at 29.82% Ryanair can block special resolutions (which allows it to prevent the disapplication of pre-emption rights and disposal of Heathrow slots); and given recent typical voter turnout (72% at the 2012 AGM), Ryanair is perilously close to being able to pass/block ordinary resolutions on a simple majority.
162. While the entire litany of interferences is long, the pensions issue bears repeating here because of its topicality and criticality for Aer Lingus. By asserting rights that it claims *as a shareholder*, Ryanair is currently opposing any payment to resolve Aer Lingus' pension issue, which may result in strikes and service disruptions for Aer Lingus, to Ryanair's direct benefit *as a competitor*. This is a naked attempt to reduce Aer Lingus' effectiveness as a competitor. It is a vivid and current illustration of the inherent and irreconcilable conflict between Ryanair's position as a shareholder and as a competitor.
163. Moreover, Ryanair's very presence on Aer Lingus' share register continues to harm Aer Lingus as a competitor. Coupled with its highly public campaign of denigration of Aer Lingus, this presence has and will continue to discourage possible M&A activity which would create a more efficient competitor and accrue to the benefit of UK consumers.

164. Ryanair's stake also acts as an impediment to the pending sale of the Irish Government's stake in Aer Lingus. The government announced some time ago its intention to sell,⁵⁶ this being part of Ireland's commitment to the Troika⁵⁷ for the reduction of the state's deficit. No timetable or process has yet been announced, however, and it is evident that the optimal sale strategy for the government hinges in part on what will become of the Ryanair holding. This is more than simply a question of the value which will be achieved on the sale (although clearly that is one consideration). It is also very much a question of the government's longstanding "two airlines" policy which has resulted in two profitable Irish based airlines competing for traffic to the benefit of consumers. One possible option for the government would be to offer its shares to the public, completing the 2006 privatisation and adding to the free float in Aer Lingus shares. This would ordinarily be attractive from the perspective of Aer Lingus' management, given its strategy of independence, but is foreclosed in practice for so long as Ryanair holds nearly 30% of Aer Lingus, since this stake would put Ryanair *de facto* in control of Aer Lingus.
165. Of course the announced intention to sell has attracted the interest of candidate purchasers, who have addressed themselves to the government – but also apparently to Ryanair, in the hope of acquiring the interests of either or both Ryanair and the government: "*Ryanair had been approached by about three different airlines and consortia interesting in buying the Government's stake*"⁵⁸

Irish Examiner

O'Leary: State could sell its Aer Lingus stake to Ryanair

Mr. O'Leary said Ryanair is happy to work with whoever buys the State's share or they could talk to them about selling their stake. "We have ruled out that we will not sell our stake with the Irish Government's, so whoever buys the stake will either have to work with us or buy our stake if they want to get control of it"

He said Ryanair had been approached by about three different airlines and consortia interested in buying the Government's stake.

⁵⁶ See Press Release, Department of Public Expenditure and Reform, *Government secures substantial reinvestment in economy from disposal of State assets*, available at <http://per.gov.ie/2012/02/22/government-secures-substantial-reinvestment-in-economy-from-disposal-of-state-assets/>.

⁵⁷ The European Union, International Monetary Fund, and the European Central Bank.

⁵⁸ Interview with Michael O'Leary, Ryanair CEO, 30 March 2012 issue of the Irish Examiner.

166. As will be seen in the interview cited from the Irish Examiner of 30 March 2012, Ryanair is thus positioning itself in the role of kingmaker to influence the future ownership and strategic direction of Aer Lingus, essentially screening future purchasers and warning them that they will have to deal with Ryanair. The vice of this situation is obvious; Ryanair should have no say in the choice of future owner of its principal rival. The OFT dealt with these concerns in its reference decision, citing EU precedents in which it was considered objectionable for one company to hold a minority stake in its competitor and thereby determine its future ownership.⁵⁹
167. In addition to these copious instances of direct efforts at harming competition by weakening Aer Lingus as a competitor, the shareholding also has effects on *Ryanair's* incentives that are qualitatively similar to those of a merger. As described in detail by the OFT in its discussion of theories of harm, holding a material share in a close competitor inevitably creates incentives to soften competition – because the negative effects of a price increase in terms of potential loss of customers are softened, if customers can mostly switch to a competitor in which one has a sizeable financial interest.
168. For all the reasons set out in this submission, and for those set out in the OFT's reference decision, Aer Lingus considers that the only outcome that will satisfactorily restore competition is a divestiture of Ryanair's holding.

59 See OFT Decision at para 180.

ANNEX 1**INTERFERENCE BY RYANAIR USING ITS MINORITY SHAREHOLDING**

1. 6 July 2007: Aer Lingus AGM at which Ryanair defeats special resolution relating to the disapplication of pre-emption rights.
2. 13 August 2007: Ryanair requisitions EGM to consider motions seeking to require Aer Lingus to maintain the Shannon–Heathrow services and take certain actions in relation to the proposed Belfast–London route.
3. 4 September 2007: Further EGM requisition relating to Shannon following company’s rejection of the 13 August requisition.
4. 14 September 2007: Correspondence received from the Financial Regulator commencing an investigation (pursuant to a complaint by Ryanair) into whether Aer Lingus complied with its disclosure obligations in relation to the announcement of its decision to cease operating the Shannon-Heathrow route. In January 2008, Ryanair initiates judicial review proceedings (in which Aer Lingus is joined as a notice party) seeking to compel the Regulator to investigate Aer Lingus and to advise Ryanair of its findings. Judgment issued rejecting Ryanair’s judicial review proceedings and costs awarded to Aer Lingus. The Financial Regulator concludes its investigation on 2 September 2008 following protracted correspondence in which it concludes that there was insufficient information to pursue the matter further.
5. 10 April 2008: EGM seeking shareholder approval in relation to the purchase of 12 longhaul aircraft. Ryanair lodges a proxy against the motion, which is passed by a majority of 63.6% for and 36.4% against.
6. 6 June 2008: Aer Lingus AGM at which Ryanair defeats three special resolutions relating to the disapplication of pre-emption rights, purchase of company shares and the reissue price range for treasury shares.
7. 1 December 2008: Ryanair announces second bid to acquire control of Aer Lingus and Aer Lingus again becomes subject to the Irish Takeover Rules. Bid subsequently lapses end January 2009 following Minister for Transport’s rejection of the offer. Judicial review proceedings taken by Ryanair against the Takeover Panel in which Aer Lingus is joined as a notice party. Proceedings subsequently withdrawn in April 2009 and Aer Lingus awarded its costs.
8. 6 January 2009: Ryanair requisitions an EGM to consider motions proposing the revocation of the change of control provisions contained in the CEO / CFO employment contracts and the censure of the Board for alleged breaches of Irish company law. Requisition rejected on the basis that clauses had already been removed and that there had been no breach of company law.

9. 27 February 2009: Ryanair puts forward 3 motions for consideration at the company's next AGM proposing reductions in directors' fees (€45,000 to €17,500) and the chairman's fees (€175,000 to €45,000) (i.e. pre-IPO levels) and that no further change of control provisions be agreed without shareholder approval. Protracted correspondence follows in which Ryanair is advised that it may propose the motions on directors'/chairman's fees as part of ordinary business at the AGM but that the motion in relation to executive contracts was not appropriate to be considered at AGM as it did not relate to ordinary business.
10. 11 March 2009: Aer Lingus publishes its 2008 Preliminary Results' Announcement containing revised guidance for 2009. Ryanair submits complaints to the Irish Takeover Panel, the Irish Stock Exchange and the London Stock Exchange alleging that Aer Lingus breached the Takeover/Listing Rules during the takeover in relation to its profit guidance for 2008/2009. The Irish Stock Exchange and the Takeover Panel subsequently confirm to Aer Lingus that their investigations have not disclosed any breach of the relevant rules.
11. 5 June 2009: Aer Lingus AGM at which Ryanair defeats special resolution relating to the disapplication of pre-emption rights. Ryanair also proposes resolutions on directors' and chairman's fees which are rejected by 98% of votes cast. Ryanair did not cast its votes but attempted to give a proxy to the Minister for Transport which was not accepted.
12. February 2010: Ryanair calls on the Irish Government to convene an EGM at which Ryanair's votes could be used along with the Government's to require Aer Lingus to surrender its lease of Hangar 6 so that Ryanair can lease Hangar 6 for its own purposes. Hangar 6 is an essential facility for the performance of Aer Lingus' line maintenance activities at Dublin Airport. It has also enabled Aer Lingus to reduce its costs by consolidating its head office functions in Hangar 6 and selling its current head office building to the Dublin Airport Authority for €22.15 million.
13. 18 June 2010: Aer Lingus AGM at which Ryanair defeats special resolutions relating to the disapplication of pre-emption rights and changes to the Aer Lingus Articles of Association reflecting the implementation of the Shareholders Rights Directive.
14. September 2010 – February 2011: Various correspondence from Ryanair to Aer Lingus raising a number of issues and seeking information relating to costs, pension deficit, the sale of the Aer Lingus Head Office Site, the payment of dividends and airport charges).
15. December 2010 – April 2011: Following an announcement issued by Aer Lingus on 21 December 2010 regarding the making of a once-off cash payment to the Employee Share Ownership Trust (the "ESOT") in order to extinguish the ESOT's borrowings and, with it, the Group's obligations to pay any further share of profits to the ESOT (the "ESOT Transaction"), Ryanair alleges that Aer Lingus has committed multiple

breaches of the Irish Listing Rules, the UK Listing Rules and Irish Company Law. Based on complaints made by Ryanair, the Office of Director of Corporate Enforcement (ODCE) initiated an investigation into the circumstances surrounding the ESOT Transaction. Following extensive engagement with Aer Lingus in relation to this complaint, the ODCE subsequently wrote to Aer Lingus stating that it had completed its investigation and was closing its file on the matter.

16. March 2011 – April 2011: Ryanair demands that Aer Lingus tables motions at its AGM to be held on 6 May 2011 requiring the payment of a dividend and preventing any further payments from being made to the pension scheme or ESOT without shareholder approval. Aer Lingus refuses to accept the motions on the basis that they contravene Irish company law and Aer Lingus' Articles of Association. Ryanair issues proceedings against Aer Lingus before the Irish High Court which rules in favour of Aer Lingus on 15 April 2011.
17. March 2011: Ryanair issues series of questions to Aer Lingus following the announcement of Aer Lingus' 2010 Full Year Results, including questions on commercially sensitive matters relating to Aer Lingus' intentions regarding fuel surcharges and its expectations in relation to future yields.
18. 6 May 2011: Aer Lingus AGM at which Ryanair defeats special resolutions relating to the disapplication of pre-emption rights and a change to the Aer Lingus Articles of Association relating to the time limits within which resolutions must be received to be included on the agenda of an extraordinary general meeting. Ryanair also votes against the re-election of a non-executive director – this motion is passed following a poll.
19. September 2011 – present: Ryanair issues further series of questions to Aer Lingus following the announcement of Aer Lingus' 2011 Half Year Results including questions on commercially sensitive matters relating to Aer Lingus' intentions regarding fuel surcharges and its expectations in relation to future yields.

September 2011 – February 2012: Further series of correspondence received from Ryanair relating to the ESOT Transaction; the settlement reached by Aer Lingus in March 2011 with the Irish Revenue Commissioners relating to tax liabilities arising from payments to staff under a restructuring programme implemented in 2009 (the "Leave and Return" programme); the payment of a dividend; and seeking assurances that no further payments will be made by Aer Lingus to any pension scheme without shareholder approval.

By letter dated 1 November, Ryanair requisitions an EGM to consider resolutions relating to (i) a request by shareholders that the independent report into the tax settlement relating to the Leave and Return programme be circulated to shareholders; and (ii) that no additional payments be made to any Aer Lingus pension schemes without prior shareholder approval. The requisition is rejected by Aer Lingus on the

grounds, inter alia, that (i) the independent report of the settlement in respect of the “Leave and Return” programme is confidential and legally privileged; and (ii) the resolution seeking to prevent any further payments to any pension scheme contravenes Irish company law and Aer Lingus’ Articles of Association for the reasons outlined by the Irish High Court in its judgement of April 2011 (see 16 above).

After a further series of correspondence, Ryanair withdraws on 9th December 2011 its request for an EGM but continues to allege that Aer Lingus’ failure to convene an EGM to consider its resolutions is unlawful as it infringes Irish company law and EU shareholder rights legislation. Ryanair continues to raise these issues in further correspondence and in an open letter addressed to Aer Lingus shareholders dated 2 February 2012, Ryanair indicates that “it intends to initiate legal proceedings to prevent the company agreeing to, or making, any such additional [pension] contributions without shareholder approval”. A similar letter is sent to the Aer Lingus Board.

20. 19th June 2012: Ryanair announces third bid to acquire control of Aer Lingus and Aer Lingus again becomes subject to the Irish Takeover Rules.

ANNEX 2**BACKGROUND INFORMATION ON RYANAIR'S INCENTIVES TO COMPETE THROUGH PARTIAL RIGHT TO AER LINGUS PROFIT STREAM**

1. The first part of this Annex provides the formulae used to calculate the values in Table 2 which compares the output decrease effect arising from a minority stake to one from a full merger by way of an illustrative example. The second part expands the points in Section 8.2 on the indications from the price pressure indices.

A. COMPARISON OF THE EFFECTS OF MINORITY STAKE AND A FULL MERGER VIA AN ILLUSTRATIVE EXAMPLE

2. Consider an example where N identical firms which sell identical products that can all be produced at a constant unit cost equal to c compete in a given market.
3. Assume that market demand takes the following simple form: $P=1-Q$ where P is the market price and Q is the total quantity sold by all firms. Firms compete by choosing their own level of output q_i simultaneously. Under these assumptions, it is straightforward to show that each firm produces $q^* = (1 - c)/(N + 1)$, for a total output of $Q^* = N(1 - c)/(N + 1)$ and a market price of $P^* = (1 + Nc)/(N + 1)$.
4. Now assume that two firms merge, so that we only have $N-1$ independent firms left in the market. This gives us the following equilibrium values: $q_M^* = (1 - c)/N$, $Q_M^* = (N - 1)(1 - c)/N$ and $P_M^* = (1 + (N - 1)c)/N$. Hence the merger leads to a contraction of total output equal to $\Delta Q_M = (1 - c)/N(N + 1)$, which corresponds to a proportional change $\Delta Q/Q = 1/N^2$.
5. Consider now a situation where one of the firms acquires a proportion $\alpha < 0.5$ of a rival. It can again be easily shown that this yields a total output of $Q_S = (1 - c)(N - \alpha)/(N + 1 - \alpha)$. Compared to the previous situation with no minority stake, this represents a decrease in output of $\Delta Q_S = \alpha(1 - c)/(N + 1)(N + 1 - \alpha)$. In the main text of this submission, Table 2 provides for a number of different values for N , the decrease in output due to full merger, the decrease in output due to a minority stake of 30% and the ratio of the latter to the former based on the above formulae.

B. FURTHER DETAIL ON A PRELIMINARY ASSESSMENT BASED ON GUPPI SUGGESTING UPWARD PRESSURE ON FARES

6. Price pressure indices help quantifying, at a preliminary level, how pricing incentives of a firm are altered due to owning a financial stake in a rival.⁶⁰ Such indices combine two main determinants of such incentives: the closeness of competition between the firms and the gross margin the rival firm makes from additional sales.
7. The logic behind price pressure indices is essentially the same as the “merger” logic described in Section 8.1 of the main text of this submission. For our example in that section with firms A and B, let us now assume that A considers increasing its price. If it does, it will lose some customers. Define these lost customers as “ L_A ”. Some of these customers will leave the market altogether, while others will just purchase B’s product instead of A’s. Define the number of customers moving from A to B as “ D_{AB} ”. If the firms are independent, then A only cares about L_A , i.e. the number of customers that it loses if it raises its price. A does not care about whether these lost customers simply disappear, or whether they now purchase from B.
8. However, let us now imagine that A and B have merged. Now A does care about the destination of its lost customers: those that leave the market are a net loss to the whole A+B entity, while the customers moving to B’s product are not, as they will now contribute to the company a profit equal to the profit margin on product B.
9. Therefore the ratio $d_{AB} = D_{AB}/L_A$, which gives the proportion of “lost customers” that are retrieved by the B side of the firm, tells us how much less A loses from raising its price once it has merged with B. This proportion is known as the diversion ratio from A to B. Clearly, where d_{AB} is higher one would expect a merger between A and B to lead to, all else equal, a higher increase in prices for A.
10. Another parameter that affects the incentive to raise price of A is the profit margin M_B on product B: the merged entity loses less from increasing the price of A (and therefore has greater incentives to do so) if M_B is large, because this margin represents the profit “recovered” on any consumer switching from A to B.
11. Upward price pressure indices such as “GUPPI” (“gross upward price pressure index”) simply formalise these ideas, combining the margin M and the diversion ratio d to give us a good idea of what the incentives for price increases resulting from a merger might be. For our merger example, “GUPPI” is defined as the multiplication of the margin for A (from additional sales), the diversion ratio from A to B and the ratio of A’s price to B’s price:

⁶⁰ In a full merger this financial stake is 100%.

$$G_{AB} = M_B d_{AB} \frac{P_B}{P_A}$$

12. For simplicity assume that prices are the same, so that the price ratio is equal to 1. Then if the relevant margin is 20%, and the diversion ratio is 50% (for instance), the GUPPI would be 10%. Generally competition authorities consider that a GUPPI of more than 10% is problematic, while a GUPPI between 5% and 10% is still worth investigating further.
13. The GUPPI approach presented above can be readily adapted to gauge the effect of minority ownership.⁶¹ If A owns a proportion α of B's shares, then A recovers only part of the profits B generates from any consumer switching from A to B and the GUPPI is simply the GUPPI under the full merger times α (the percentage of B's profits that A has a claim on):

$$G_{AB} = \alpha M_B d_{AB} \frac{P_B}{P_A}$$

14. We can then use this adapted GUPPI formula to evaluate the extent of "gross upward price pressure" that is likely associated with Ryanair's stake in Aer Lingus. Reflecting Ryanair's ~30% claim on Aer Lingus' profits, we can assume $\alpha = 0.3$. The diversion ratio d_{AB} would likely differ across markets (i.e., across routes between city pairs), or be calculated for a broader "UK-Ireland routes" market.
15. As described in the main text, for a number of O/D pairs Ryanair and Aer Lingus are the only airlines providing direct flights. On such routes, it is very likely that a substantial proportion of passengers who would leave Ryanair following a fare increase would fly instead with Aer Lingus. The only other alternatives would be to not fly at all, or to fly between the same two cities but through an indirect route. As the routes over which Ryanair and Aer Lingus overlap are short-haul routes, the additional inconvenience associated with using an indirect route is likely to be considerable. If no Ryanair passenger defecting due to a fare rise would fly on an alternative route (or use an alternative method of transport) then Aer Lingus would gain all lost Ryanair passengers. It seems therefore reasonable to assume that for routes on which they are the only competitors providing direct flights, the diversion ratio between Ryanair and Aer Lingus would be rather close to 100%. Alternatively if we were to consider a broader Ireland to UK market, where the two airlines have a joint market share of about 80%, it would seem reasonable to assume that the

⁶¹ An extensive discussion of how a partial financial interest in a rival affects the pricing incentives of a firm can be found in O'Brien, D. P. and S. Salop, 2000, "Competitive Effects of Partial Ownership: financial Interest and corporate Control", *Antitrust Law Journal*, 67: pp. 50 – 65.

proportion of travellers that Ryanair would lose following a fare hike who would switch to Aer Lingus would be in excess of 60%.

16. On the other hand, the rate of profit Aer Lingus makes from the revenue it earns on selling more tickets on its existing flights due to some passengers diverting from Ryanair is also likely to be significant. Where Aer Lingus can accommodate an additional passenger (switching from Ryanair) on an existing flight the increase in its costs due to carrying this additional passenger could be minimal since few cost items for that flight would change (e.g., aircraft and crew costs would not be affected by carrying an additional passenger on an existing flight, though there would be some impact on fuel costs).
17. If this profit margin were above 30%⁶², then even if the diversion from Ryanair to Aer Lingus was only 60% (a conservative value for routes between UK and Ireland where the two airlines are the only ones offering direct flights), then Ryanair's shareholding of 29.82% would imply a GUPPI above 5%. Table A1 below presents a few other combinations of margins and diversion ratios that lie in what appears to be the reasonable ranges.

Table A3: GUPPI for A Minority Ownership of 30%

Diversion ratio	Profit Margin		
	30%	40%	50%
50%	4.5%	6.0%	7.5%
60%	5.4%	7.2%	9.0%
70%	6.3%	8.4%	10.5%
80%	7.2%	9.6%	12.0%
90%	8.1%	10.8%	13.5%

18. Except for one case, all combinations of margins and diversion ratios give rise to GUPPI in the range that competition authorities tend to find problematic. The possibility that Ryanair's shareholding in Aer Lingus might give rise to an SLC on at least some routes between the UK and Ireland, as a result of its impact on Ryanair's

⁶² On [CONFIDENTIAL] of the five UK/Ireland routes where the two airlines are the only competitors offering direct flights Aer Lingus has achieved profit margins [CONFIDENTIAL] in 2010 according to its [CONFIDENTIAL](in which only direct aircraft, passenger and cargo related operating costs are deducted from revenues). Its margin on London – Dublin route, where Aer Lingus and Ryanair are not the only competitors but have a very large combined market share, was also [CONFIDENTIAL].

incentives to raise fares, should therefore be thoroughly assessed by the CC in its investigation.

19. As a final comment: we have couched the effect of Ryanair's stake in Aer Lingus on Ryanair's own incentives to compete in terms of fare levels. However, this stake can also have similar effects in terms of Ryanair's entry and exit behaviour. Suppose that absent the shareholding, Ryanair would find it marginally profitable to enter on a route currently served by Aer Lingus. The shareholding may imply that the rational entry decision for Ryanair switches from "enter" to "not enter". This is because just as the shareholding would lead Ryanair to internalise (at least partially) the negative impact of lower Ryanair fares on Aer Lingus on existing overlap routes, it would also lead it to internalise the negative impact of Ryanair's entry on Aer Lingus on this new route. Mutatis mutandis, the same argument implies that, because of its stake in Aer Lingus, Ryanair might be more likely to exit a marginally profitable route on which Aer Lingus is also active.
20. On the basis of a similar approach the OFT has considered that on overlap routes the impact of the shareholding in increasing Ryanair's incentives to compete less intensively with Aer Lingus was sufficiently high to meet the reference test.⁶³

63 Under the assumption that on a route where Ryanair and Aer Lingus are the only airlines offering direct flights a passenger defecting Ryanair would fly with Aer Lingus, the relevant GUPPI on certain routes [CONFIDENTIAL] when Aer Lingus' margins based on [CONFIDENTIAL] are used.