Competition Act 1998

No Grounds for Action Decision

No. MPINF-PSWA001 – 04

Alleged abuse of a dominant position by Flybe Limited

Annexe B – Analysis of Costs and Revenues

(Case MPINF-PSWA001)

OFT1286

Please note that [...] indicates figures or text which have been deleted or replaced in ranges at the request of the parties or third parties for reasons of commercial confidentiality.

ANNEXE B - ANALYSIS OF COSTS AND REVENUES

THE OFT'S METHODOLOGY

B.1 The OFT's analysis of costs and revenue involves a consideration of:

- the relevant level of output
- the relevant time period over which to measure revenues and costs
- the categories of cost to be included
- the relevant revenues to be included in the analysis.

THE RELEVANT COST BENCHMARK

B.2 Following the European Commission's Guidance[1] the OFT considers it is appropriate to review the available financial information to assess whether prices have been charged at a level lower than average cost. In its Guidance[2] the European Commission states:

'26. The cost benchmarks that the Commission is likely to use are average avoidable cost (AAC) and long-run average incremental cost (LRAIC). Failure to cover AAC indicates that the dominant undertaking is sacrificing profits in the short term and that an equally efficient competitor cannot serve the targeted customers without incurring a loss. LRAIC is usually above AAC because, in contrast to AAC (which only includes fixed costs if incurred during the period under examination), LRAIC includes product specific fixed costs made before the period in which allegedly abusive conduct took place. Failure to cover LRAIC indicates that the dominant undertaking is not recovering all the (attributable) fixed costs of producing the good or service in question and that an equally efficient competitor could be foreclosed from the market.'

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[1] Communication from the Commission - *Guidance on the Commission's enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings* available at eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2009:045:0007:0020:EN:PDF

[2] Ibid.

B.3 In line with the Commission's Guidance,[3] the OFT has used an AAC model to consider possible profit sacrifice. The OFT believes this is more appropriate measure in general than Average Variable Costs, although the results would be the same in this case if Average Variable Costs were used, [4] as the OFT would consider costs variable to Flybe's decision to enter the Newquay - London Gatwick route.

B.4 In this case, in accordance with the Commission's Guidance,[5] the OFT has considered whether Flybe's AAC from entering the Newquay - London Gatwick route have exceeded its revenues. As the OFT is considering whether Flybe's decision to enter the Newquay - London Gatwick route constituted an abuse, it considers that AAC should also include fixed costs involved in setting up the route, as these would have been avoided had Flybe not decided to enter. Therefore, the OFT considers that there is no distinction between LRAIC and AAC in this case.

B.5 The OFT's cost analysis below shows that Flybe's AAC have exceeded its revenues in the first 18 months of operation. However, this does not necessarily imply that Flybe's actions were predatory for several reasons. Flybe was a new entrant to the Newquay - London Gatwick route and was not dominant on that route. In addition, to establish foreclosure, the OFT must establish special circumstances that warrant a finding of abuse on a market related to that on which Flybe is dominant. This is analysed in more detail in Section 6 of the main decision.

B.6 The OFT considers that this case differs from cases where the conduct in question is a pricing decision of an existing incumbent, as Flybe is a new entrant. In this case the OFT has noted that, as an entrant on the Newquay - London Gatwick route, it is relevant to consider the pattern of Flybe's returns and costs that may be expected from entry on to a new route. These revenues and costs may evolve over time. As such, the time period over which to measure revenues and costs is of particular significance.

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[3] Ibid.

[4] Ibid at footnote 40 states 'In most cases the AVC and AAC will be the same, as often only variable costs can be avoided. However, in circumstances where AVC and AAC differ, the latter better reflects possible sacrifice: for example, if the dominant undertaking had to expand capacity in order to be able to predate, then the sunk costs of that extra capacity should be taken into account in looking at the dominant undertaking's losses. Those costs would be reflected in the AAC, but not the AVC'.

[5] Ibid.

THE RELEVANT LEVEL OF OUTPUT

B.7 When assessing an allegation of predation, it is necessary to determine the correct output level to which to apply the cost analysis. In this case, the abuse is alleged to have occurred on the Newquay - London Gatwick market. The OFT considers that the Newquay - London Gatwick route represents the relevant level of output for applying the analysis of costs in this case.

THE RELEVANT TIME PERIOD OVER WHICH TO MEASURE REVENUES AND COSTS

B.8 The relevant time period is usually the time over which the alleged predation prevailed or could reasonably be expected to prevail. The OFT considers that generally, the longer the period considered in an investigation of predation, the more costs become avoidable as commitments expire and/or alternative uses of the existing resources become available.

B.9 This case relates to a situation where an airline has entered on to a route. As such routes may take time to develop and attract customers, it is also relevant in this case to consider the time period over which an airline may reasonably expect a route to become profitable under conditions of normal competition. Assessing costs and revenues over too short a period may lead to the apparent identification of an abusive sacrifice where a finding of start-up losses consistent with normal competition could be a more accurate description of events.

B.10 Flybe has submitted that the normal path to profitability for a given route depends on whether that route is intended to be an 'anchor' route or 'filler' route. An 'anchor' route is defined by Flybe as a long term strategic investment with two or more flights a day, year round, with an expectation of reaching maturity and profitability in three years, with solid profitability expected subsequently. A 'filler' route is defined by Flybe as being one which operates on a frequency of one per day or fewer, mainly being seasonal routes (some are all year round) whose aim is to achieve short-term seasonal profitability and a contribution over DOCs.[6] Flybe states that a filler route is a tactical way of using spare capacity. Flybe submits that it intended Newquay - London Gatwick to be an 'anchor'

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[6] Letter from Flybe's legal advisers to the OFT dated 4 December 2009.

route and that this implies a path to profitability of up to three years in accordance with normal commercial behaviour.[7]

B.11 The OFT considers that it must assess what, in its view, is a reasonable period of time over which a new entrant to a route should seek to achieve profitability, if it is to establish that pricing below AAC is not abusive. This involves a consideration of what is normal in the economic context of the airlines market. One year may be too short a period over which to assess profitability, yet the OFT cannot accept without question Flybe's submission that three years is normal. The OFT has considered the position over different time periods, so that an assessment can be made 'in the round'.

B.12 In undertaking its assessment of whether AAC are in excess of revenue, the OFT can only work with Flybe's actual and forecast data. Flybe has provided the OFT with actual financial information for the first 18 months of operations of the Newquay - London Gatwick route (February 2009 - July 2010). In addition, Flybe has provided the OFT with forecast data for the first three years of operation of the Newquay - London Gatwick route. Therefore, the OFT's analysis of financial sacrifice is applied to both Flybe's actual results since entering the Newquay - London Gatwick route and to Flybe's three-year projections.

B.13 To place the Newquay - London Gatwick route in a broader context, the OFT has also conducted a benchmarking exercise which compares Flybe's projected performance on the Newquay - London Gatwick route with actual performance on other routes. This is discussed in paragraphs B.38 - B.59, below.

THE CATEGORIES OF COST TO BE INCLUDED

B.14 Flybe provided cost data in response to the OFT's request, divided between Direct Operating Costs (DOC) and Fixed Operating Costs (FOC) and overheads. This division was consistent with its management accounts, and distinguished between variable operating costs, that is, costs that would vary with the level of the activity and fixed operating costs, that is, costs that would not depend on the level of activity. Flybe also provided a measure of overhead costs. It also distinguished between passenger DOC and

[7] Ibid.

sector[8] DOC, according to its perspective of the main driver of the costs. Additional detail of the costs included within these categories within Flybe's management accounts is shown below:

- [...]

B.15 Flybe has submitted that it considered both passenger and sector DOC were equivalent to average variable costs.[9] The OFT considers that both the passenger and sector DOC would have been avoided if Flybe had not commenced operations and includes these items within AAC. However, the OFT also considers that some of the FOC would be avoidable.

B.16 The OFT has identified the categories of cost within FOC that it considers to be avoidable. The OFT has attempted to be conservative in its approach by excluding from its definition of avoidable costs those costs whose avoidability was questionable.

B.17 The OFT outlines below its reasoning for assessing whether different categories of costs are avoidable or not.

SECTOR DIRECT OPERATING COSTS (DOC)

B.18 The OFT considers that both passenger DOC and sector DOC are avoidable. Passenger DOC would be expected to vary directly with the number of passengers so would be expected to be avoided had Flybe not entered the route. Similarly sector DOC, including such items as [...].

[...]

Media advertising

B.19 Media advertising costs are allocated to individual routes according to the number of passengers on each route. Flybe has advised the OFT that 'Flybe's typical style of marketing is to promote many routes together on specific advertisements and

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[8] 'Sector' - A leg of a journey Newquay to London Gatwick would be considered a sector.

[9] Flybe submission to the OFT dated 28 July 2009, paragraph 4.16.

promotional materials, rather than advertising one particular route or destination'.[10] The OFT considers that it might have been possible to make an incremental reduction in media costs if there had been one less route to advertise, particularly as a new route would generally have greater prominence in any advertising of routes. However, over the course of a single year it is unlikely that Flybe would adjust its annual media budget based on the cancelation of a single route. In order to produce a conservative analysis of Flybe's potential profit sacrifice the OFT have treated this cost as unavoidable. In any event, the OFT notes that media advertising would represent [...] per cent of costs and would not materially affect its findings below.

Aircraft lease and insurance

B.20 Flybe has submitted the details of a standard lease agreement to the OFT.[11]

B.21 In the OFT's view, Flybe could potentially avoid costs relating to aircraft lease and insurance in two ways.

- Flybe could sublease aircraft to other companies, provided it could secure any required permission to do so.
- Flybe might be able to reallocate aircraft to operate on other routes, or replace aircraft with shorter-term lease arrangements with the lease on those aircraft not being renewed.

B.22 In June 2009 Flybe wet leased four of its aircraft to Olympic Airlines. This suggests that sub letting of its aircrafts is not uncommon and that the leasing firm is not adverse to such arrangements. Consequently, the OFT considers the costs to be avoidable.

Crew cost

B.23 The OFT considers that crew would be required to fly aircraft as long as a route is operated, but not otherwise. Flybe operates on a number of routes and will have some staff turnover. Consequently, it would appear possible to reallocate crew, not replace

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[10] Letter from Flybe's legal advisers to OFT dated 11 January 2010.
[11] Ibid.

staff following natural wastage or terminate staff contracts over a period of a year or more. Therefore, the OFT considers crew costs to be avoidable.

Base cost

B.24 These costs include aircraft parking, cleaning, station costs and executive lounge costs.[12] In the OFT's view, the 'executive lounge costs' are not likely to be avoidable as Flybe has other routes and passengers from these routes would also be expected to use the facilities. Some of the other costs, for example, cleaning would be expected to be avoided if the flights did not operate. As a further analysis of these costs is not available, the OFT has made the conservative assumption that all such costs are unavoidable.

Line maintenance

B.25 These costs include the manpower and materials costs of running a line maintenance facility.[13] The OFT considers that some of these costs could be avoided by not running the route, but there may be economies of scope/scale with other routes, which might be lost if the facility was scaled down. The OFT has taken a conservative approach and assumed that none of these costs are avoidable. The OFT notes that line maintenance constitutes [...] per cent of total costs and would not make a material difference to the analysis.

Aircraft hire

B.26 This includes the cost of leasing of additional aircraft if there were shortages of aircraft.[14] As the need for aircraft would not arise if the route was not operated, the OFT considers these costs to be avoidable.

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[12] Letter from Flybe's legal advisers to OFT dated 11 January 2010

[13] Letter from Flybe's legal advisers to OFT dated 11 January 2010.

[14] Letter from Flybe's legal advisers to OFT dated 11 January 2010.

Overheads

B.27 These costs would be a contribution to central or head office costs[15] and are unlikely to vary as a result of an additional route being operated. The OFT considers these costs to be unavoidable.

B.28 The OFT's proposed treatment of costs for the different cost categories is summarised in the table below, which also shows the proportion of each cost category relative to the total.

[15] Letter from Flybe's legal advisers to OFT dated 11 January 2010.

Proposed Treatment of Cost Categories

Cost category	Cost Type	Percentage of total operating costs[16]	Avoidable Cost
Commission	[...]	[...]	✓
Passenger Surcharge	[...]	[...]	✓
Passenger Handling	[...]	[...]	✓
Passenger Res Costs	[...]	[...]	✓
Delay and Diversion	[...]	[...]	✓
Passenger Liability Insurance	[...]	[...]	✓
Passenger Discounts*	[...]	[...]	✓
Fuel	[...]	[...]	✓
Landing	[...]	[...]	✓
Handling	[...]	[...]	✓
Catering	[...]	[...]	✓
Eurocontrol	[...]	[...]	✓
Maintenance	[...]	[...]	✓
Crew Hotac & Travel and Allowances	[...]	[...]	✓
Sector Discounts*	[...]	[...]	✓
Media Advertising	[...]	[...]	✗
Aircraft Lease and Insurance	[...]	[...]	✓
Crew Cost	[...]	[...]	✓
Base Cost	[...]	[...]	✗
Line Maintenance	[...]	[...]	✗
Aircraft Hire	[...]	[...]	✓

* Passenger Discounts are discounts to Passenger Direct Operating Costs and Sector Discounts are discounts to Sector Direct Operating Costs.

[16] Note: The percentages listed are the average proportion of these costs over the period February 2009 - July 2010.

THE RELEVANT REVENUES TO BE INCLUDED

B.29 The OFT notes that Flybe has separated its revenue between passenger seat sales and ancillary revenue in its actual results. Flybe has submitted that ancillary revenue comprises revenue earned from charges other than the ticket itself including debit and credit card charges, a charge for advance seat assignment, a charge for checking in baggage, and sales of food, drink and other merchandise on the flight.[17] The OFT considers all such revenue to be avoidable if the route was not operated and has therefore included these revenues in its analysis.

RESULTS OF THE COST AND REVENUE ANALYSIS

Actual performance - Feb 2009 - July 2010

B.30 The following table summarises the results for the Newquay - London Gatwick route when comparing avoidable cost, with the revenue that was dependent on the route operating. This approach has been applied to actual performance data between February 2009 and July 2010.

Table B.1: Results of the cost test to date (actual figures in £ thousands)

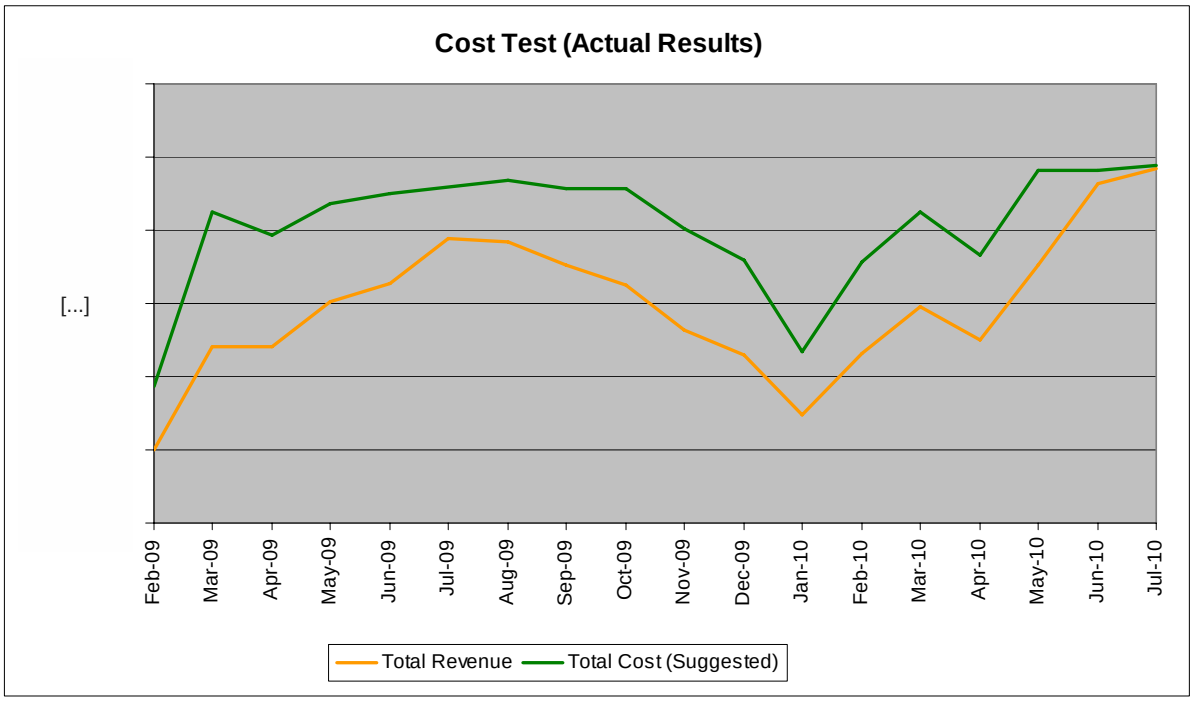
	Newquay - London Gatwick
Revenue	[...]
Avoidable cost	[...]
Contribution (Revenue minus avoidable cost)	[...]
Contribution as a percentage of revenue	[...]

[17] Letter from Flybe's legal advisers to the OFT dated 4 December 2009.

B.31 The table shows that revenue from the Newquay - London Gatwick route failed to cover its avoidable costs since Flybe began operating on the route. Revenue would have had to rise by at least [...] per cent to cover avoidable costs.

B.32 Overall, the route has made a negative contribution of £[...] over 18 months. Revenue was below avoidable cost in every month, though in June and July 2010 revenue is almost equal to avoidable cost.

Figure B.1: Cost Analysis (Actual Results)

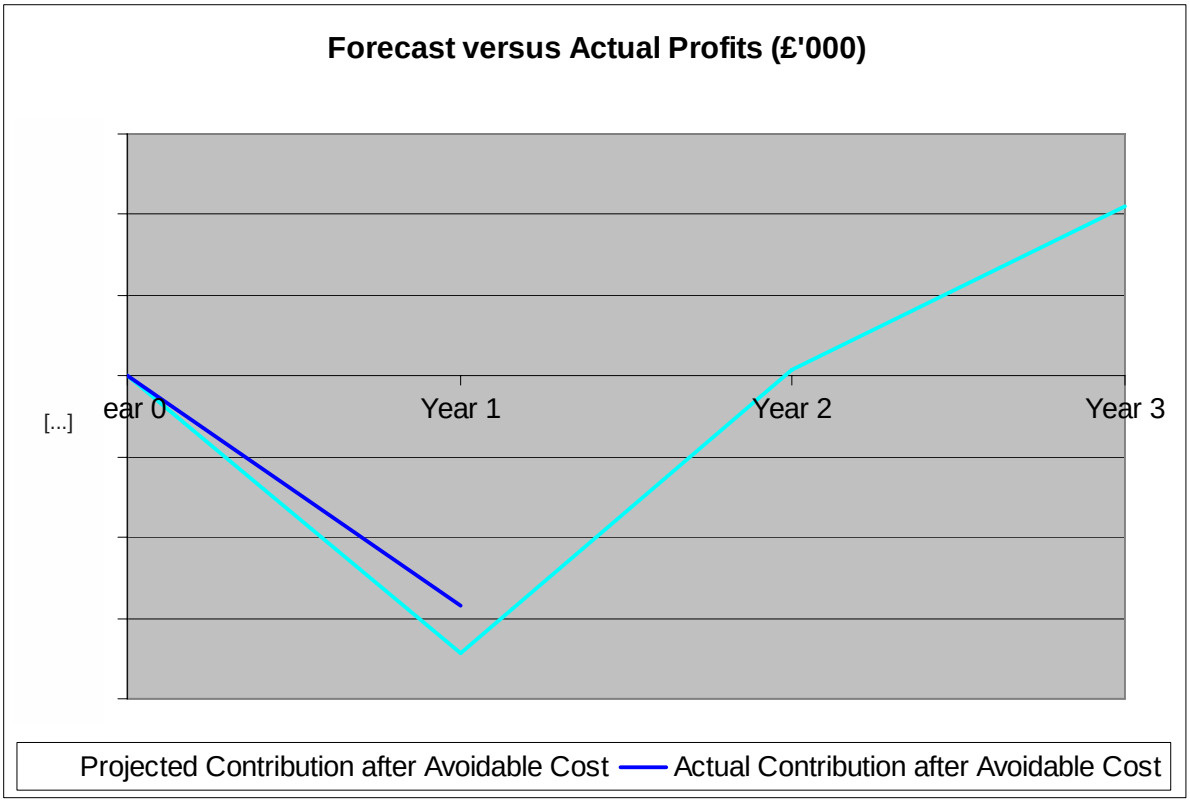


Forecast performance - Years 1-3

B.33 Flybe has provided details of its financial forecast for the first three years operation of the Newquay - London Gatwick route to the OFT. As these are forecasts and so subjective, the OFT considers that less weight should be placed on their informative value. On the other hand, the OFT notes that the data is helpful in considering Flybe's ex ante expectations.

B.34 Figure B.2 below illustrates the difference between Flybe's projected performance in its first year of operation and its actual performance, which showed slightly lower losses.

Figure B.2: comparison of Flybe's actual performance to projected performance on Newquay - London Gatwick



B.35 The OFT has used this data as the basis of an analysis of Flybe's expectations, specifically whether Flybe expected to earn revenues below AAC in the years of operation subsequent to its entry on to the Newquay - London Gatwick route. The OFT has used the same definition of AAC as in its assessment of Flybe's actual performance.

B.36 Table B.2 below illustrates Flybe's year by year projected performance on the route.

Table B.2: Cost Test (Forecast Figures in £ '000)[18]

	Year 1	Year 2	Year 3
Revenue	[...]	[...]	[...]
Average avoidable cost	[...]	[...]	[...]
Contribution	[...]	[...]	[...]
Contribution as a proportion of revenue	[...]	[...]	[...]

B.37 The forecast shows that Flybe expected to have a shortfall between revenue and AAC in the first year, but would have shown revenue marginally higher than AAC in the second year. Revenue was expected to exceed AAC in year three. Taking the three years cumulatively, revenue would fall short of AAC by £[...].

BENCHMARKING AGAINST FLYBE'S ACTUAL PERFORMANCE ON OTHER ROUTES

B.38 Flybe claims that initial losses incurred when entering a route are the result of normal competitive behaviour. In this regard, Flybe has submitted the following view expressed by Tim Coombs of Aviation Economics:[19]

'A newly-opened route will usually take at least a year and sometimes as much as three years to become profitable. Failure to reach profitability after a period of up to three years will usually result in the route being closed.'

B.39 Flybe has submitted that there are several reasons for airlines to experience these initial losses on entering a route:[20]

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[18] From Flybe's submission of the 10th December 2009, Annex 50, LGW-NQY Business Plan dated Nov /Dec 2008, OFT calculations.

[19] *'Flybe Limited Submission to the OFT'* dated 28 July 2009.

[20] Ibid.

- The need to invest up-front marketing costs to create public awareness of the new route.
- The competitor reaction which leads to lower pricing and increased frequency.
- The use of introductory fares to stimulate demand.
- The long time to build up average load factors, related to the period over which the route gains maturity.
- The sharp variation in of airline profits according to the seasons.

B.40 The OFT notes that several of these reasons may be pertinent to its assessment of Flybe's costs and revenues arising from its entry onto the Newquay - London Gatwick route, specifically the competitor reaction to entry, the use of introductory fares to stimulate demand and the long time to build up average load factors. The OFT considers that the seasonal variation in airline profits would not have a significant impact on an assessment of revenues over several years.

B.41 The OFT notes the following views independently expressed by third parties, regarding initial losses made by airlines on entering routes. In *Aer Lingus v British Midland*, the European Commission commented that airlines would expect to incur some losses during an initial period, although they do not give an idea of how long the initial period would be:[21]

'When an airline commences a new service, it will normally expect to incur some losses during an initial period, during which it will have to organize economic operation of its service and to attract sufficient interest from the travel trade and from travellers. It cannot expe[c]t to attain the load factors and the revenue necessary to ensure profitable operations from the beginning of the service. Therefore new entry will always be difficult.'

[21] Commission decision of 26 February 1992, *British Midland and Aer Lingus* OJ (1992) L 96/34, paragraph 27.

B.42 Further, certain low cost carriers in Australia have been prepared to enter onto routes expecting losses for the first year or two after entry[22] and the OFT notes a presentation by Simat, Helliesen & Eichner (an aviation consultancy firm) which states that airlines often lose money when starting up new routes and that airlines' expectations on starting new routes is that they will make losses in year one, break even in year two and become profitable in year three.[23]

B.43 The OFT considers initial loss making may in certain circumstances be pro-competitive where it is needed to stimulate demand in order to generate sales on entering a new market. In the case of an airline entering a route, initial losses incurred may be recouped in later years as the demand for the route grows.[24] As such, the OFT considers that the earning of revenues below AAC for an initial period after entry onto an airline route may not necessarily be a clear indication of sacrifice, though the initial period would be limited and might be expected to be less than three years.

B.44 The OFT has considered Flybe's conduct on other routes as a benchmark for Flybe's conduct in this case. In this regard, the OFT has compared Flybe's projected performance[25] on the Newquay - London Gatwick route with its actual performance in

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[22] *Low cost carriers in Australia: experiences and impacts*, Forsyth, 2003, paragraph 3.2, published in the Journal of Air Transport Management 9 (2003), pages 277 - 284.

[23] The OFT refers to slide 3 of a presentation by Eliot Lees of Simat, Helliesen & Eichner (an aviation consultancy firm) dated 16 March 2010 (available at www.sh-e.com/presentations/lees_2_031610.pdf), which states that airlines often lose money when starting up new routes and that airlines' expectations on starting new routes are that they will make losses in year one, break even in year two and become profitable in year three. The OFT also notes slide 2 in a presentation entitled 'Route Planning and Evaluation' prepared by Dr Peter P Belobaba, dated 15 March 2006 (which can be found at http://ocw.mit.edu/courses/aeronautics-and-astronautics/16-75j-airline-management-spring-2006/lecture-notes/) which states 'Strategic considerations can overlook lack of route profit: Longer term competitive and market presence benefits of entering a new route even if it is expected to be unprofitable in short run'.

[24] In this context, the OFT refers to slide 3 of a presentation by Eliot Lees of Simat, Helliesen & Eichner (an aviation consultancy firm) dated 16 March 2010 (available at www.sh-e.com/presentations/lees_2_031610.pdf), which states that airlines often lose money when starting up new routes and that airlines' expectations on starting new routes are that they will make losses in year one, breakeven in year two and become profitable in year three

[25] Flybe's projections for the Newquay - London Gatwick route rather than actual performance have been considered in order to compare profitability over three years rather than just the first year. As shown in figure B.2, Flybe's projections for the Newquay - London Gatwick route have been broadly consistent with its actual performance.

the years following its entry onto other routes. If Flybe's claim that airlines typically incur substantial initial losses on entering a route is justified, in the OFT's view, its actual performance on other routes should follow a similar profile to that projected for the Newquay - London Gatwick route, that is Flybe should incur initial losses for the first year, followed by small losses in the second year and profits in subsequent years. The comparison is based on profit after costs including overheads.

B.45 The OFT has considered whether Flybe's profitability after entry onto other routes forms a good basis for comparison, mindful of the danger of comparing Flybe's behaviour on Newquay - London Gatwick with other routes where Flybe might have engaged in abusive behaviour. The OFT considers it unlikely that, in all the other examples of entry it has analysed, Flybe was dominant in a market that was sufficiently proximate to these routes for the entry to constitute abuse. It considers it likely that most, if not all, of these other examples may be regarded as competition on the merits. The OFT has also considered these points in further detail with reference to particular routes analysed in the benchmarking comparison. As such, the OFT considers the benchmarking comparison to be instructive in determining whether Flybe deliberately sacrificed profits on the Newquay - London Gatwick route.

B.46 Flybe has submitted that it has developed a 'financial matrix' over the last seven years which allows it to forecast the path of the overall financial performance of new routes started in each year with a high level of accuracy.[26] The financial matrix consists of the key performance statistics of all the routes Flybe has entered since 2003/04, aggregated according to the number of years since each route was opened. Flybe has provided to the OFT both the financial matrix and the disaggregated route by route information on which it is based. From Flybe's financial matrix: [27]

- In their first year of operation, the average losses on Flybe's routes are [...] per cent of route turnover.
- In their second year, Flybe's routes have lost on average [...] per cent of turnover.

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[26] '*Flybe Limited Submission to the OFT*' dated 28 July 2009.

[27] Profitability in this context has been measured net of all costs, including overheads. The figures presented are therefore not directly comparable to the measures of contribution over AAC presented for Newquay - London Gatwick above.

- In their third year, Flybe's routes have made a profit on average of [...] per cent of turnover.

- In their fourth year, Flybe's routes have made a profit on average of [...] per cent of turnover.

- In their fifth year, Flybe's routes have made a profit on average of [...] per cent of turnover.

B.47 The financial matrix shows that Flybe's historic performance overall is consistent with its claim that it typically incurs losses in the first two years after entry onto a route and only breaks even in the third year.

B.48 In addition, the OFT has identified and considered in more detail specific routes with similar actual profitability to Flybe's projected performance on the Newquay - London Gatwick route. In doing so, the OFT has considered Flybe's absolute profitability, its profitability per passenger and its profitability relative to revenue. Only routes with more than 300 flights in a year have been included in this analysis so as to exclude routes on which Flybe only has provided a temporary or seasonal service. Flybe's overall profitability on each route has been considered rather than a measure of revenues minus AAC as the data available to the OFT on each route did not allow it to identify specifically which costs were avoidable. In any event, the OFT considers that overall profitability is a reasonable basis for comparing performance across routes to determine whether the losses projected for Newquay - London Gatwick are exceptional.

B.49 The first year actual profitability of the least profitable routes in the first year after Flybe's entry is shown in the table below. Flybe's first year forecast for Newquay - London Gatwick is also included for comparison. Routes on which Flybe took over existing BA Connect operations are identified in the table, as are routes where there was no incumbent airline at the time of Flybe's entry.

Table B.3: First year profitability of least profitable routes

	[…]	[…]	[…]	[…]	[…]	[…]	[…]
[…]	[…]	[…]	[…]	[…]	[…]	[…]	[…]
[…]	[…]	[…]	[…]	[…]	[…]	[…]	[…]
[…]	[…]	[…]	[…]	[…]	[…]	[…]	[…]
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[…]	[…]	[…]	[…]	[…]	[…]	[…]	[…]
[…]	[…]	[…]	[…]	[…]	[…]	[…]	[…]

[...]

B.50 The OFT notes that there are certain Flybe routes with similar absolute first year losses to Newquay - London Gatwick. While the Newquay - London Gatwick forecast is for a complete year, certain routes may not have commenced at the beginning of the financial year and as such the data is not for a whole year. The OFT considers this to be an important caveat in comparing absolute profitability.[28] Further, the extent of losses on Newquay - London Gatwick is to a certain extent likely to be a reflection of the large number of flights operating on the route.

B.51 For these reasons, profitability per passenger or profitability as a proportion of revenue may be a more robust measure in comparing first year profitability. There are a number of routes that were less profitable than Newquay - London Gatwick in terms of net profit per passenger in their first year, while some routes have a similar profitability per passenger to Newquay - London Gatwick. In terms of loss relative to revenue, only two routes made larger losses than Newquay - London Gatwick.

B.52 In interpreting this comparison, the OFT is mindful of the possibility that Flybe's profitability on certain routes may have been planned in a way to make short run losses in order to eliminate the incumbent from the route. The OFT has therefore considered whether it is appropriate to use these routes as a benchmark.

B.53 Flybe has provided evidence to the OFT regarding its launch of the [...] routes.[29] According to Flybe's financial projections,[30] both were expected to make losses - [...].[31] Both of these routes are still in operation despite the substantial initial losses. One of Flybe's main competitors at [...], exited [...] a year after Flybe entered on to the route. However, [...] remains in head-to-head competition with Flybe on [...].

The OFT sent a section 26 notice to Flybe in December 2009 requesting documentation relating to the launch of the [...] routes. Surprisingly, Flybe provided few documents in

[28] This problem will not apply to the second and third financial years.

[29] [...]

[30] These projections were provided with a letter from Flybe's legal advisers to the OFT dated 4 December 2009.

[31] Ibid, Annex 2.

response so the OFT was unable to draw any conclusions with regard to Flybe's motivations in entering these two routes. [...][32]

[...][33]

B.54 The OFT also notes that a number of routes where Flybe took over BA Connect's operations following its acquisition of BA Connect experienced significant losses in the first year of operation. Flybe made significant losses on commencing operations to [...]. In particular, on the [...] route Flybe experienced similar losses (£[...]) to those projected for Newquay - London Gatwick. On the [...] route there was no other incumbent airline when Flybe took over BA Connect's operations, ruling out the elimination of the incumbent as a motivation for the substantial initial losses (£[...]) incurred by Flybe.

B.55 The table below tracks the actual performance of Flybe's least profitable routes into their second year of operation. Data is only available up until the financial year 2008/09, so only the results of routes that started prior to 2008/09 can be shown in the table.

Table B.4: Second year profitability

	[...]	[...]	[...]	[...]	[...]	[...]	[...]
[...]	[...]	[...]	[...]	[...]	[...]	[...]	[...]
[...]	[...]	[...]	[...]	[...]	[...]	[...]	[...]
[...]	[...]	[...]	[...]	[...]	[...]	[...]	[...]
[...]	[...]	[...]	[...]	[...]	[...]	[...]	[...]
[...]	[...]	[...]	[...]	[...]	[...]	[...]	[...]
[...]	[...]	[...]	[...]	[...]	[...]	[...]	[...]

[32] [...]
[33] [...]

[...]	[...]	[...]	[...]	[...]	[...]	[...]	[...]
[...]	[...]	[...]	[...]	[...]	[...]	[...]	[...]
[...]	[...]	[...]	[...]	[...]	[...]	[...]	[...]
[...]	[...]	[...]	[...]	[...]	[...]	[...]	[...]
[...]	[...]	[...]	[...]	[...]	[...]	[...]	[...]
[...]	[...]	[...]	[...]	[...]	[...]	[...]	[...]
[...]	[...]	[...]	[...]	[...]	[...]	[...]	[...]
[...]	[...]	[...]	[...]	[...]	[...]	[...]	[...]
[...]	[...]	[...]	[...]	[...]	[...]	[...]	[...]
[...]	[...]	[...]	[...]	[...]	[...]	[...]	[...]

[...]

B.56 All of the routes continued to make losses in their second year with the exception of [...], although performance on most of the routes improved. Second year losses on several of the routes are greater than those projected for Newquay - London Gatwick.

B.57 Flybe's projections for revenue growth between the first and second year of operation on Newquay - London Gatwick is [...] per cent, principally driven by an increase in the projected number of passengers. This is not out of line with actual revenue growth experienced on some of Flybe's other routes. In particular, revenues on [...] have grown by more than [...] per cent.

B.58 The table below tracks the actual performance of these routes into their third year of operation. Data is only available for the routes that started prior to 2007/08. The performance of all the routes has improved in their third year of operation although the [...] route has remained unprofitable. [...] has continued to grow in terms of revenue and profitability.

Table B.5: Third year profitability

	[...]	[...]	[...]	[...]	[...]	[...]	[...]
[...]	[...]	[...]	[...]	[...]	[...]	[...]	[...]
[...]	[...]	[...]	[...]	[...]	[...]	[...]	[...]
[...]	[...]	[...]	[...]	[...]	[...]	[...]	[...]
[...]	[...]	[...]	[...]	[...]	[...]	[...]	[...]

CONCLUSION ON ANALYSIS OF REVENUES AND COSTS

B.59 The OFT considers that, had Flybe been an incumbent operator in a position of dominance on the Newquay - London Gatwick route, then the evidence that it projected and actually earned revenues below AAC for one year would be evidence of sacrifice.

B.60 However, Flybe is an entrant and the OFT has found it not to be dominant on the route. Further, it considers that the sample of routes used in the benchmarking indicates that the initial losses projected by Flybe on the Newquay - London Gatwick route are not exceptional. In particular, Flybe's first year actual performance on certain routes is similar to that projected on the Newquay - London Gatwick route. As a consequence, the OFT does not consider that the extent of losses below AAC projected by Flybe on the Newquay - London Gatwick route for the first year of operation is evidence of sacrifice.