

Agenda

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No-fly zone? A curious case of alleged predation by a new entrant

Following the entry of UK airline, Flybe, onto a domestic air route that put it in competition with Air Southwest (ASW), the UK Office of Fair Trading (OFT) launched an investigation into whether the entry represented an abuse of a dominant position by Flybe. The OFT's theory of harm was that Flybe might be attempting to eliminate ASW from all routes, thus benefiting Flybe's other routes operating from a nearby regional airport. After a 17-month investigation, the OFT concluded that Flybe had not breached competition law

The 2010 *Flybe* case contained novel elements that make it an important development in competition policy.¹ The alleged 'predator', Flybe, was a new entrant into the market in which predation was alleged to have occurred. The 'victim' of the predation—and the complainant in the case—was ASW, an airline that (on some possible market definitions) had, until a few weeks before launching its complaint, held a monopoly in the market in which predation was alleged. During much of the OFT's investigation, ASW held a market share that was greater than, or around the same as, that of the predator. Moreover, under the OFT's theory of harm, recoupment was not expected to occur in the market in which there was predation—instead, the theory was that recoupment could happen in an 'associated' market.

The Flybe case is important also because the OFT, following a 17-month investigation, chose to issue a fully reasoned decision that there had not been an infringement of the Competition Act 1998. This unusual choice brings the advantage of providing increased certainty to other parties in future, and assisting in the development of criteria for predation under competition law.

Background to the case

The *Flybe* case concerned the air route between Newquay Cornwall Airport and London Gatwick Airport. The incumbent on this route was ASW, which took it over in 2003 when British Airways stopped operating it. At the time of Flybe's entry, ASW flew four flights a day between Newquay and London. The majority of ASW's operations were based at Plymouth City Airport in the south-west of England, from where it provided flights to ten destinations, all within the British Isles.

Flybe started operating the Newquay–Gatwick route in February 2009, offering three rotations a day, at times similar to the flights provided by ASW, but with one fewer rotation in the middle of the day. Flybe offers services to and from a range of destinations across Europe—particularly in the UK, where it was, at the time, the second-largest domestic airline—and its main base in the UK is at Exeter Airport, also in the south-west of England.

The third competitor on services between London and Newquay was Ryanair, which at the time of Flybe's entry operated services between London Stansted and Newquay; however, in October 2009 it withdrew from the route.

Following Flybe's entry, ASW launched its complaint to the OFT in March 2009, at which point the OFT opened proceedings against Flybe.

The OFT's theories of harm

Given Flybe's status as a new entrant onto the route between London and Newquay, the OFT's theory of harm was not based on the 'standard' model of predatory pricing, where a firm is dominant, behaves in a predatory manner, and recoups within a single economic market. Even if Flybe had entered at prices below the relevant cost floor for assessing predation, at the time of entry the airline could not have been dominant on the route. Although its market share could be assessed on the basis of a number of different market definitions—notably, depending upon the treatment of Ryanair's route between Stansted and Newquay—on none of the possible market definitions did Flybe hold a market share considerably larger than that of ASW.² Consequently, and in light of Flybe's

Oxera advised Flybe in this investigation.

recent entry onto the London to Newquay route, the OFT found that Flybe was not dominant in the focal market. As such, there could be no abuse of a dominant position on the Newquay to Gatwick route, and the OFT did not pursue a theory that Flybe was attempting to eliminate ASW from that route with the aim of recouping its losses, after ASW's exit, by making excessive profits on the same route.

Consequently, the theory of harm pursued by the OFT related to the interaction of the Newquay to London air route with other routes operated by ASW and Flybe, from Plymouth and Exeter Airports respectively. As the OFT set out in its decision (paragraph 3.8):

ASW asserted that Flybe's conduct was not simply an attempt to force ASW off the Newquay – London Gatwick route but was an attempt to exclude it more widely from the airline market. The OFT therefore considered whether there was a plausible story of harm that Flybe's conduct may have involved deliberately making losses, intended not only to exclude ASW from the Newquay – London Gatwick route, but also from wider operations at Plymouth Airport, with the aim of protecting and strengthening Flybe's alleged position of substantial market power at Exeter Airport.

Therefore, the OFT's theory was not that, by engaging in predatory behaviour on the London–Newquay route, Flybe might strengthen its dominant position on that route. Rather, it was that, by predating on Gatwick–Newquay, Flybe might be able to eliminate ASW as a *whole*, provoking it to drop services from Plymouth Airport, which competed with Flybe's base at Exeter. In formal terms, the air market(s) at Exeter Airport might experience 'associative links' to the Newquay–London aviation market.

A number of factors seemed to lend support to the OFT's putative theory of harm. Plymouth Airport is the closest airport to the west of Flybe's main base airport in Exeter, located around an hour's drive away. The other two closest airports are to the east: both Bristol and Bournemouth Airports are within two hours' drive. All other airports are more than two hours' drive away. Plymouth Airport therefore appears to be one of a handful of airports that might compete with Exeter Airport.

Moreover, there were several routes (the 'focal routes') that were operated by ASW from Plymouth and by Flybe from Exeter, and where the two airlines might therefore act as competitive constraints on one another. Among these were routes to Dublin, Glasgow, Guernsey, Jersey, Leeds Bradford, Manchester, and Newcastle. Consequently, unless there were effective competition from other airports or other modes of transport, there might be scope for Flybe to benefit

from any reduction in competition and so recoup on these routes any losses that it had made in engaging in predatory behaviour against ASW.

Finally, the business plans and outturn results of Flybe demonstrated that, immediately after entry onto the Newquay to Gatwick route, the airline was making losses by operating these services. In its first year after entry, Flybe did not cover its average avoidable costs (AAC) of operation, although from the third year onwards revenues were expected to exceed its AAC. This led the OFT to conclude that Flybe was pricing below cost.

As a consequence, the OFT sought to investigate the theory of harm that stated that Flybe had attempted to eliminate ASW and its base at Plymouth by engaging in predatory behaviour on the route between Gatwick and Newquay.

Requirements for the OFT's theory to hold

As set out above, the OFT's allegations against Flybe were based on the principle of associated markets. However, for the OFT's theory to hold, a lengthy sequence of empirical and economic findings was required. The difficulty in satisfying this sequence means that, although the OFT's case was logical and could be satisfied in theory, in practice it is hard to see how there would be many instances where a case of this type could be successfully prosecuted.

The conditions that would need to be satisfied to support the OFT's theory of harm are as follows.

- 1. Before Flybe's entry, the Gatwick–Newquay route must have been incrementally profitable for ASW.** If this were not the case then even before Flybe's competition on the route, there would have been incentives for ASW to exit the route. Moreover, the Gatwick–Newquay route could not in this case have been providing profits to support other routes.
- 2. ASW's incremental profits on the Gatwick–Newquay route must have been higher than its total profits as a company.** Consequently, all the other routes combined (plus the fixed overhead costs of the company) must have been loss-making. If this condition did not hold, then even if Flybe were to engage in behaviour which made operating on the Gatwick–Newquay route very unprofitable for ASW, ASW would have retained the option to withdraw from the route and continue operating its other routes as before, remaining as a profitable firm.
- 3. ASW must not have been able to make itself profitable again by dropping a sub-set of routes from Plymouth.** The OFT's theory of harm is based

on ASW being eliminated by Flybe's behaviour. If ASW were merely to have retrenched from some portion of routes, it would have remained as an active potential competitor on all its previous routes (and, indeed, on others which it had not previously operated) and continued to impose a competitive constraint on Flybe.

4. **ASW must have been efficient, or at least as efficient as Flybe.** One of the core elements of the test for predatory pricing is that the conduct should be capable of excluding a firm as efficient as the alleged predator (in this case, Flybe). In this case, there were some concerns around the efficiency of ASW, including its lack of advertising expenditure, absence from global distribution systems,³ and the 'triangular' operation of flights on various routes (ie, some of the ASW flights between Gatwick and Newquay were indirect). If these concerns were justified, even if ASW were made unprofitable by Flybe's entry, it does not necessarily follow that an efficient airline would also have been excluded.
5. **Incumbency advantages must not have been too large.** In general, firms alleged to be engaged in predatory behaviour have a number of advantages in the market, including having a stronger brand than firms that are allegedly being preyed, and associated customer loyalty. In the *Flybe* case, the advantages of incumbency accrued to the firm allegedly being preyed, rather than to the predator. This would tend to mean that the costs of any predation in this case would be higher than in a 'standard' case with the predator as the advantaged firm. If incumbency advantages were very large, an efficient incumbent would have been able to fight off any predatory attempts, or make them so costly as to eliminate any incentives to undertake them in the first place.
6. **The Gatwick–Newquay route should not have been in the same market as the Stansted–Newquay route.** As set out above, Ryanair was active on the route between Stansted and Newquay, alongside the ASW route between Gatwick and Newquay. If Stansted and Gatwick were in the same market for passengers travelling between Newquay and London, there would have been an expectation that Ryanair would impose an active competitive constraint on ASW, and ASW would not be able to make a sufficient level of profits on the Gatwick to Newquay route to enable it to cross-subsidise a set of otherwise loss-making routes between other airports.
7. **Passengers must have been willing to switch from using Plymouth Airport to using Exeter Airport when ASW ceased its operations.** If Flybe did not find it profitable to predate, it would be unlikely to do so in practice. The OFT's theory of harm is

based on abuse of dominance, and recoupment, on Flybe's routes out of Exeter following ASW's exit from its Plymouth base. Consequently, there must have been scope for Flybe to increase its prices or load factors on its routes from Exeter after ASW ceased operations at Plymouth.

8. **Flybe must not have faced fully effective competitive constraints on the routes where its operations from Exeter Airport overlapped with those from Plymouth after ASW's exit.** If Flybe faced fully effective competitive constraints, it would have been unable to make supernormal profits from its routes from Exeter, and would therefore have been unable to use these routes to recoup its costs of engaging in predatory behaviour.
9. **There must not have been re-entry at Plymouth Airport after any successful predation.** If there had been scope for re-entry, this would have undermined the possibility of recoupment, since the competitive situation would tend to revert to a situation similar to that before ASW's exit.

It can readily be seen that this is an extensive list of conditions, and one that is likely to be satisfied only in a very limited set of conditions. Overall, therefore, it seems unlikely that there will be many cases where the 'associated markets' theory of predatory entry could be factually satisfied.

The OFT's analysis

The OFT did not assess in detail all the conditions set out above for its theory of harm to hold (although it considered some of them in greater or lesser depth): it did not need to do so, given its ultimate finding that Flybe had not engaged in predatory behaviour.

The key element to the OFT's analysis appears to have been an analysis of the costs and motives for entry, which brought together two conflicting strands. On the one hand, there were a number of internal emails from within Flybe, which indicated to the OFT that there might have been a rationale for predatory behaviour—that Flybe wished to prevent ASW being purchased by another company, which might increase the competitive threat posed by the takeover company, and that Flybe executives believed that the company's operations at Exeter Airport would benefit from a withdrawal of ASW's services at Plymouth.

On the other hand, the evidence of below-cost pricing was not considered by the OFT to be supportive of its case. The OFT first observed in its decision (paragraph 6.28) that:

there may well be an important distinction to be made between pricing below cost when entering a new market and launching a new

service and pricing below cost as the incumbent in order to deter a competitor. This distinction may be required in order not to prevent dominant companies from entering new markets.

It went on to set out evidence of below-cost pricing by airlines when launching new routes, from a range of cases previously considered by various competition authorities. It found that this demonstrated that a period of below-cost pricing would be expected when an airline (whether dominant or not) started operations on any new route, but did not reach a conclusion on how long such losses would be expected to continue. It also took as a benchmark for 'normal' losses on entry the extent of first-year losses on other routes where Flybe was a new entrant. It was found that the losses on Gatwick–Newquay were large, but remained similar to the losses on other routes where Flybe had established operations.

The OFT reached the overall conclusion that there had not been predatory entry by Flybe. The main reason for this finding appears to be that it found that the losses incurred upon entry by Flybe were not of a predatory nature, since they were consistent with those expected under normal, 'albeit robust' competition.⁴

Conclusions

The *Flybe* case is both interesting and instructive for future predatory pricing cases under EU competition law. The OFT undertook detailed analysis to judge the evidence against its theory of harm—although this was a theory that would have required very specific circumstances in order to hold. In the end, the conclusion it reached appears to have been broadly supported by later events, which saw ASW being successfully sold to Eastern Airways in September 2010.⁵ However, subsequent to this, the owners of Plymouth Airport, Sutton Harbour Holdings, announced that it intended to close the airport by the end of 2011, and, three months later, ASW announced that it was ceasing all operations from both Newquay and Plymouth Airports.⁶

In such a complex and contentious area of competition economics, it is particularly important to be able to provide firms and advisers with clarity on how particular courses of action will be viewed. The OFT's decision makes a sizeable contribution to the case law on predatory pricing cases where the alleged predator is a new entrant and the effects of the predatory conduct may be felt in an associated market.

¹ Office of Fair Trading (2010), 'No Grounds for Action Decision: Alleged Abuse of a Dominant Position by Flybe Limited', Case No. MPINF-PSWA001-04, December.

² Even on the basis of the narrowest possible market (Newquay to Gatwick flights only, with London City and Stansted Airports not being treated as viable substitutes), Flybe held a market share of 56% during 2009, and ASW 44%. On the widest market considered by the OFT (Newquay to all London airports), Flybe held a market share of 33%, ASW 33%, and Ryanair 34%. Office of Fair Trading (2010), *op. cit.*, p. 59, table 5.1.

³ Global Distribution Systems are aviation industry-wide computer systems that enable travel agents to see all available flights to or from a given airport or airports.

⁴ Office of Fair Trading (2010), *op. cit.*, para 6.116.

⁵ See: http://www.airsouthwest.com/news/shownews.php?ne_id=282.

⁶ See: <http://www.sutton-harbour.co.uk/news.asp?NewsID=168> and http://www.airsouthwest.com/news/shownews.php?ne_id=308.

If you have any questions regarding the issues raised in this article, please contact the editor, Dr Gunnar Niels: tel +44 (0) 1865 253 000 or email g_niels@oxera.com

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