

Completed acquisition by Air France finance S.A.S / City Jet Ltd of VLM Airlines N.V.

ME/3535/08

The OFT's decision on reference under section 33(1) given on 9 May 2008. Full text of decision published 10 June 2008.

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## **PARTIES**

1. **Air France KLM S.A. (AFKL)** is active principally in air transportation (passengers and freight) but also in ground services (for example, passenger handling). AFKL owns over 92 per cent of the economic rights in **KLM Royal Dutch Airlines (KLM)**, a Dutch registered international carrier operating scheduled cargo and passenger services to more than 90 destinations principally from Amsterdam. AFKL is a founding member of the SkyTeam Alliance and has two international hubs at Amsterdam Schiphol and Paris CDG airports. AFKL's vehicles for this acquisition are its wholly-owned subsidiaries, **Air France Finance S.A.S.**, and the latter's subsidiary, **City Jet Ltd (City Jet)**, a regional European airline serving ten of its current seventeen routes from its hub at London City Airport.
2. **VLM Airlines N.V. (VLM)** is a Belgian-registered regional airline. VLM is active in the supply of scheduled short-haul point-to-point passenger air transport services, primarily focused on business customers. For the IATA summer 2008 season, VLM operates eight routes on a reverse-hub basis at London City Airport, with most of its aircraft and personnel based in The Netherlands and in Belgium.

## **TRANSACTION**

3. The transaction comprises the acquisition by Air France Finance S.A.S. ([...]) of the entire issued share capital of VLM together with [...] Fokker 50 aircraft for €[...].

4. The transaction was completed on 14 February 2008. The OFT's statutory deadline in the present case is therefore 14 June 2008. The parties submitted an informal merger notification on 22 February 2008. The OFT's extended administrative deadline expires on 9 May 2008.

## **JURISDICTION**

5. As a result of this transaction, AFKL and VLM have ceased to be distinct. In the year ended 31 December 2006 (last financial year for which audited financial information is available), VLM generated a UK turnover of £[...], which, accordingly, does not satisfy the turnover threshold set out in Section 23(1)(b) of the Enterprise Act (the Act).
6. However, the transaction qualifies as a relevant merger situation on the share of supply test set out in Section 23(4) of the Act as the parties' combined share of supply in the UK for scheduled air transport services between Amsterdam and LCY (in which both parties are active) exceeds the 25 per cent threshold.
7. The OFT therefore believes that it is or may be the case that a relevant merger situation has been created.

## **MARKET DEFINITION**

8. As will be detailed below, the focus of this transaction are routes between various London airports and Dutch airports, as follows:

London City (LCY)	Amsterdam Schiphol (AMS)
London Heathrow (LHR)	Rotterdam (RTM)
London Gatwick (LGW)	
London Stansted (STN)	
London Luton (LTN)	
<b>All London airports (LON)</b>	

9. The parties overlap in the provision of direct business and leisure passenger air transport services on LON—AMS and LON—RTM.

10. For passenger air transport services, definition of the relevant product and geographic markets is inextricably linked. Past decisional practice<sup>1</sup> has considered the relevant starting point for market definition of scheduled passenger air transport services to be origin and destination (O&D) pairs (that is, city-to-city pairs).
11. In line with recent OFT, Competition Commission (CC) and European Commission (EC) decisions, the OFT considers below whether it is appropriate to narrow or widen the market definition from the starting point of a particular O&D pair (that is, LON—AMS and LON—RTM).
12. In this respect, the OFT considers the following distinctions in relation to LON—AMS and LON—RTM: (i) direct and indirect services (ii) scheduled and charter services, (iii) business and leisure passengers and (iv) LCY versus other London airports.

#### **Direct vs. indirect flights**

13. In the light of previous OFT<sup>2</sup> and EC<sup>3</sup> decisions and in accordance with third party responses, the OFT takes a cautious view and excludes indirect flights from the present analysis. The OFT has received no evidence that suggests that it should deviate in this case from the approach taken in previous cases.

#### **Scheduled vs. charter flights**

14. In accordance with EC and CC reasoning in previous cases,<sup>4</sup> the parties submit that charter passenger air transport services are a separate relevant market from scheduled passenger air transport services. The OFT has not received any evidence in the course of the present case to depart from

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<sup>1</sup> Competition Commission: British Airways plc and Cityflyer Express Limited: *A report on the proposed merger* (July 1999); ME/2795/06: Anticipated acquisition by Flybe Group Limited of the BA Connect business of British Airways plc (OFT decision of 20 June 2007); ME/3399/07 Anticipated acquisition by easyJet Airline Company Limited of GB Airways Limited (OFT decision of 24 January 2008); Case COMP/M.3280 Air France/KLM (11 February 2004).

<sup>2</sup> ME/2795/06: Anticipated acquisition by Flybe Group Limited of the BA Connect business of British Airways plc (OFT decision of 20 June 2007); ME/3399/07 Anticipated acquisition by easyJet Airline Company Limited of GB Airways Limited (OFT decision of 24 January 2008).

<sup>3</sup> Case COMP/M4439 Ryanair/Aer Lingus (27 June 2007); Case COMP/M.3280 Air France/KLM (11 February 2004).

previous decisional practice of treating charter and scheduled passenger air transport services separately. Given the parties' minimal overlap in the supply of charter passenger air transport services, this type of service is not considered further.

### **Business vs. leisure passengers**

15. In line with previous decisional practice,<sup>5</sup> the parties submit that business and leisure passenger air transport services form two separate markets (business passengers being defined as time-sensitive passengers travelling on flexible economy or business class tickets, and leisure passengers being defined as non-time sensitive passengers travelling on non-flexible economy tickets).<sup>6</sup> The OFT notes that four large business customers ([...]) contacted in the context of the present analysis suggest that they do not see business and leisure passenger air transport services as being substitutable.
16. In this regard, the parties further submit that the overlap routes predominantly serve business passengers. In support of this, they refer to a recently-conducted survey of VLM passengers (the VLM survey)<sup>7</sup> stating that [70-80] per cent of VLM passengers flying between LCY and AMS, and [80-90] per cent flying between LCY and RTM, are business passengers.
17. For present purposes, the OFT therefore assesses the transaction separately for both business and leisure air passenger transport services.

### **O&D pairs at LCY vs. other London airports**

18. The parties submit that the correct approach in the present case is to decide on a route-by-route basis whether services flown from LCY and the other London airports (LHR, LGW, STN and LTN) are substitutable, and not to consider whether, over all routes, services from LCY compete with those from other London airports. In this context, the parties further submit that in

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<sup>4</sup> Respectively Case COMP/M.2008 – AOM/Air Liberte/Air Littoral (27 July 2000) and Competition Commission: British Airways plc and CityFlyer Express Limited: *A report on the proposed merger* (July 1999).

<sup>5</sup> Competition Commission: British Airways plc and CityFlyer Express Limited: *A report on the proposed merger* (July 1999); Case COMP/M.3280 Air France/KLM (11 February 2004).

<sup>6</sup> Flexible economy and business class tickets are those that allow passengers to 'turn up and go' on any flight that day (sometimes for a fee), whereas non-flexible economy tickets restrict passengers to travelling on specified flights.

<sup>7</sup> VLM commissioned a survey from a market research organisation called d-sense that surveyed 1,088 customers on VLM's (then) 11 routes between 23 January 2007 and 10 April 2007.

line with previous decisional practice on airport substitutability and according to the VLM survey evidence, the relevant market in terms of business passenger services is limited to LCY—AMS, whereas the relevant market in terms of leisure passenger services covers all London airports.

#### Previous decisional practice

19. In *Flybe/BA Connect*,<sup>8</sup> the OFT stated that the extent to which flights from neighbouring airports may impose a competitive constraint on services between airport pairs will depend on a number of factors including the extent to which the catchments of potentially competing airports overlap and the sensitivity of passengers to time travelled to and from the airport. On this occasion, the OFT noted that certain flights (early morning, late afternoon and evening flights) are likely to be predominantly used by business passengers and are therefore likely to be priced accordingly. It was found that, while business passengers may have become more sensitive to price, there was no evidence to suggest that journey time or frequency had become significantly less important to business passengers such that they would be likely to either travel to neighbouring airports or fly with airlines operating a less convenient schedule. Thus, the OFT formed the view that business travellers are less likely than leisure passengers to travel to neighbouring airports.
20. In *easyJet/GB Airways*<sup>9</sup> the OFT reiterated that the extent to which passenger air transport services from neighbouring airports (albeit predominantly leisure passenger air transport services) may impose a competitive constraint on each other depended upon factors such as catchment area overlap and the time sensitivity of passengers.
21. In its 1999 report on the *British Airways plc and Cityflyer Express Limited*<sup>10</sup> merger, the CC assessed the relevant market for London airports. While adopting an initial O&D approach, the CC distinguished three main market segments: the service for point-to-point leisure passengers, the service for point-to-point business passengers and the service for connecting passengers. With regard to point-to-point leisure passengers, the CC

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<sup>8</sup> ME/2795/06: Anticipated acquisition by Flybe Group Limited of the BA Connect business of British Airways plc (OFT decision of 20 June 2007).

<sup>9</sup> ME/3399/07 Anticipated acquisition by easyJet Airline Company Limited of GB Airways Limited (OFT decision of 24 January 2008).

<sup>10</sup> Competition Commission: *British Airways plc and CityFlyer Express Limited: A report on the proposed merger* (July 1999); Case COMP/M.3280 Air France/KLM (11 February 2004).

declared itself satisfied that services to a single destination from any or all of the London airports were operating in the same market. For point-to-point business passengers, it took the view that LCY was well placed to offer an alternative to LHR or LGW for business travellers starting their journey in central London. The CC took into account the following factors when assessing demand side substitutability between London airports for business passengers: (i) high frequencies and service standards, (ii) early morning departure and late evening return for short haul services, (iii) minimal travel time and (iv) the quality of rail and road links.

22. In *Ryanair/Aer Lingus*<sup>11</sup> the EC focussed its analysis on leisure/non-time sensitive passengers flying to and from Dublin, and concluded that scheduled point-to-point passenger air transport services between Dublin and LHR, LGW, LTN and LCY belonged in the same market.

The OFT's approach

23. Below, the OFT considers whether LCY and other London airports are substitutable for direct, scheduled business and leisure passenger air transport services to AMS and RTM from both demand- and supply-side perspectives.

#### **Demand side substitution**

Business passengers

24. The OFT has regard to the previous decisional practice presented above, and also considers the following set of evidence gathered in the course of the investigation in relation to (i) the type of passengers travelling via LCY, (ii) their sensitivity to time travelled, (iii) catchment areas in London, AMS and RTM. The OFT also takes into account (iv) the model relied upon by British Airways (BA) to measure the impact of its newly launched LCY—AMS service on its currently operated LHR—AMS service and finally, (v) other third party comments relating to the present transaction.

(i) Type of passengers travelling via LCY airport

25. The OFT notes that LCY was designed to cater primarily for business passengers travelling from and to London's financial districts, Canary Wharf and the City. In that respect, figures from the Civil Aviation Authority (CAA)

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<sup>11</sup> Case No. COMP/M.4439 27 June 2007.

indicate that the percentage of time-sensitive business passengers using LCY is significantly higher—around 64 per cent of all passengers using LCY—than it is at other London airports. Furthermore, these figures show that all other London airports cater for more leisure than business passengers. However, as recognised by the parties in absolute terms, significant numbers of business passengers also fly to and from LHR.

26. The survey evidence provided by the parties corroborates the proposition that a majority of passengers flying via LCY are time-sensitive business passengers: in a sample of more than 1,000 VLM passengers, when asked the purpose of their flight with VLM, [80-90] per cent overall stated that they were flying on business and in particular [70-80] per cent on LCY—AMS and [80-90] per cent on LCY—RTM.

(ii) Passengers' sensitivity to time travelled

27. The parties submit that business passengers are more time sensitive and therefore will prefer a service that enables them to reach their destination more quickly even if that service is more expensive. In this regard, the parties provide shortest total travel times from central London to AMS and RTM airports for services via each of the five London airports, which show that:<sup>12</sup>

- the overall travel time taken to fly through LCY to AMS compared with the overall travel times taken to fly from other London airports to AMS is 54 to 60 minutes shorter, and
- the overall travel time taken to fly through LCY to RTM compared with the overall travel times taken to fly from other London airports to RTM is 76 to 80 minutes shorter.

28. The OFT finds that the high proportion of business passengers characterising LCY's customer base combined with the relatively short travel time taken to fly from LCY to AMS or RTM appears consistent with the proposition that a significant number of time sensitive business passengers located in or close to central London, when offered similar schedules, would be likely to choose the LCY—AMS or LCY—RTM service in preference to a service flown from another London airport.

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<sup>12</sup> Travel time includes average flight time plus average check-in and security clearance time plus the shorter of the average journey time to central London by car or taxi and the minimum journey time to central London by public transport.

(iii) Catchment areas in London, Amsterdam and Rotterdam

29. The parties submit that the catchment areas for business passengers in the present case are smaller than the 100 km radius used by the CC and the EC in their decisional practice. In this respect, the VLM survey data establishes that:
- for passengers beginning their journey in London: [80-90] per cent begin their journey within 50 km of LCY, and [50-60] per cent travel less than 20 km to reach LCY
  - for passengers beginning their journey at AMS, [80-90] per cent travel less than 50 km, and
  - for passengers beginning their journey at RTM, [80-90] per cent travel less than 50 km.
30. The parties acknowledge that business passengers travelling out from and back to London within the same day would be likely to prefer to start their outward journey from home in the morning, rather than from their work place in the City or central London. However, the VLM survey evidence reveals that only [20-30] per cent of respondents returned the same evening to LCY whereas the rest, approximately [...] of VLM passengers, spent at least one night away from home on business. The parties submit that, accordingly, it is likely that a number of these passengers start and end their business journey from their work place in the City or central London.
31. In light of the above, the OFT acknowledges that the survey data presented above suggest a narrow approach to airport catchment areas in London, Amsterdam and Rotterdam, when considering business passengers.
32. However, the OFT also takes into consideration the CC study on '*catchment areas of BAA and other main airports in Scotland and South-east England*'<sup>13</sup>, which suggests that LCY's and LHR's catchments areas overlap to a certain extent. In particular, the most important London borough catchments for LCY are the City of London (with 15 per cent of passengers originating there), Westminster (13 per cent) and Tower Hamlets (11 per cent), and the most important London borough catchments for LHR are Westminster (11 per cent) and Kensington and Chelsea (6 per cent). Therefore the catchments of LCY and LHR overlap in the London borough of Westminster,

which suggests that LCY and LHR compete with each other to a certain extent. A third party response to OFT questions confirms this.

(iv) BA's cannibalisation model

33. Anticipating the likely impact of the new LCY—AMS services based on the number of LHR—AMS bookings, BA indicates to the OFT that it expected its LCY—AMS service to gain 40 per cent of its passengers from its LHR—AMS service. BA also indicates that its two current LON—AMS routes (that is, LHR—AMS and LGW—AMS) compete with the parties' LCY—AMS services. In this respect, the OFT believes that LCY does place some constraint on LHR.

(v) Other third party comments

34. Four other airlines' responses to OFT questions indicate that they view LCY as a business airport. Out of four large customers (accounting for [...] of AFKL's business on LCY—AMS and [...] of VLM's) who responded to the OFT's questionnaire, three do not think that flights to AMS and RTM from London airports other than LCY imposed a constraint on LCY—AMS or LCY—RTM.
35. Other evidence from customers is somewhat mixed, with some saying that—although they may be forced to accept a 10 per cent price increase by the merged entity—they would also try to switch some business to other London airports. Finally, in response to the OFT's questionnaire, LCY indicates that it sees all London airports and in particular LHR as competing with LCY.
36. In light of the above, the OFT acknowledges that LHR certainly is LCY's closest competitor and in that respect does allow for some competitive constraint to be placed on routes served out of LCY.

Leisure passengers

37. The parties submit that leisure passengers are more readily prepared to travel to an airport for a flight so that the relevant market in relation to leisure air transport services to AMS and RTM includes all London airports.

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<sup>13</sup> See Appendix D of CC's emerging thinking report on BAA Airports (published on 22 April 2008).

38. Given that LCY—AMS and LCY—RTM are predominantly business routes, information and evidence provided to the OFT on leisure passengers are lacking. However, a third party focussing predominantly on leisure passengers indicates to the OFT that alternative routes (from other London airports) would be viewed by passengers as substitutes for LCY—AMS and LCY—RTM to the extent that routes to the same destination are available. In addition, OFT econometric analysis of data provided by the same third party shows that the third party's average monthly yields on its routes to AMS from one London airport are statistically significantly affected by its yields and load factors at the other London airports, consistent with all London airports being in the same relevant market.
39. Finally, the OFT has not received any evidence to depart from its previous decisional practice of treating the market for air transport services to leisure passengers as London-wide.

#### **Supply side substitution**

40. The OFT considers below the ability of airlines not operating on routes from LCY to AMS and RTM, to use existing slot [Endnote 1] holdings and aircrafts to switch from one route to another when prices on a route rise (slot flexing).
41. The parties submit that BA, bmi, and easyJet could flex their existing capacity at London airports, although technical barriers would limit the extent of such a practice (specifically, the short runway at LCY means only turboprop or small jets with specially trained pilots can use the airport).<sup>14</sup>
42. On this point, the OFT has received a mixed set of responses from third party airlines present at LCY: two airlines consider it easy to enter/expand on LCY—AMS and LCY—RTM by re-deploying slots at LCY. Another airline says that re-deploying slots to be used across different routes is relatively easy but that its aircraft cannot operate from LCY. Another airline comments that re-deploying slots at LCY is difficult and re-deploying them at other London airports essentially is impossible.
43. In terms of examples of supply-side substitution through slot flexing, the OFT notes that Air France stopped flying LGW—Strasbourg and started flying LCY—Strasbourg. In the same vein, Airport Coordination Ltd (ACL)

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<sup>14</sup> This presumably presupposes that they can obtain slots at LCY.

confirms that airlines occasionally use this flexibility to optimise their use of slots.

44. However, for supply-side substitution to broaden the relevant market in response to a change in relative yields between two routes, it would need to be (near-) instantaneous and (near-) costless. Overall, the OFT has not seen evidence showing that slots at LCY or at all London airports could be used in such a way to provide passenger air transport services to and from different destinations in order to arbitrage profitable differences in yields. On the contrary, the OFT notes that slot flexing for an airline appears to require a minimum time period of six months (to plan the route at the relevant bi-annual IATA slot conference), and involves major opportunity costs given the current scarcity of slots at London airports (in particular at LHR and LCY during peak times). In conclusion, although slot flexing seems plausible, the OFT does not believe that very short-term slot flexing responses may be feasible enough or profitable enough to affect competition in a manner consistent with interpreting slot flexing as supply side substitution.
45. It follows that supply side substitution in the form of slot flexing may not be considered in the present case as widening the relevant market to include all London airports. However, the OFT notes that slot flexing—as considered later in the decision—may be characterised as expansion by existing players.

#### Conclusion on LCY vs. other London airports

46. The OFT considers that for **business** passenger air transport services operated between LCY and respectively AMS and RTM, there is some evidence to support the view that the relevant market may extend more widely than LCY, in respect of which the OFT considers that LHR is LCY's closest competitor. However, the best view of the evidence available at this stage is to consider that, for the purposes of the AMS route, LCY—AMS is a separate O&D-pair market.
47. In any event, unilateral effects concerns arise on the AMS route even on the basis of a market comprising both LCY and LHR as points of origin. The duty to refer in this case is therefore insensitive to the other most plausible candidate market considered.

48. The OFT is of the view that **leisure** passenger air transport services operated between LCY and AMS and RTM respectively form part of wider market which embraces all London airports.

### **Conclusion on market definition**

49. On the basis of the above, the OFT's analysis focuses on: (i) direct, scheduled leisure passenger air transport services on LON—AMS; (ii) direct, scheduled business passenger air transport services on LCY—AMS; (iii) direct, scheduled leisure passenger air transport services on LON—RTM; and (iv) direct, scheduled business passenger air transport services on LCY—RTM.

### **HORIZONTAL ISSUES**

50. VLM operates to RTM from LCY, whereas AFKL operates to RTM from LHR and STN. Accordingly, the transaction does not result in any horizontal overlaps for direct, scheduled business passenger air transport services to RTM. Overlaps for the other three relevant markets are considered below, as well as the issue of potential competition on the non-overlap LCY—RTM (business) route.
51. For the three relevant overlap markets (i, ii and iii above), the parties provide market share figures on the basis of bookings data from MIDT (Marketing Information Data Transfer). These data have three advantages: firstly, they report bookings on specific O&D pairs carrier-by-carrier; secondly, they capture and make a distinction between passengers on the O&D pair and passengers travelling from and to other destinations (that is, connecting passengers); and thirdly, MIDT bookings data can identify passengers with business class or fully flexible economy tickets in contrast to those travelling with a less flexible economy ticket (assumed to be leisure/non-time sensitive passengers). Notwithstanding this, the parties identify two limitations of MIDT bookings data: firstly, these data record bookings, not the number of passengers actually flying (passenger numbers are, however, available from other sources); and, secondly, MIDT data does not record the bookings of several low cost airlines (although the parties have imputed low cost airlines' shares of bookings on the basis of their shares of passengers and estimates of their split between leisure and business passengers). The OFT acknowledges that, although MIDT data are less reliable where low cost airlines operate on a route, they have the particular merit in this case of

showing the balance between time sensitive (business) and non-time sensitive (leisure) passengers.

#### **LON—AMS (leisure)**

52. LON—AMS is currently served by five airlines of which: two are traditional network carriers (AFKL and BA); one (bmi) is a network carrier that has reconfigured its operations over the last few years to include a low cost subsidiary (bmi Baby); another (VLM) is a regional airline; and one is a low cost or no-frills airline (easyJet). In that context, the parties estimate their combined shares of supply for leisure passengers on LON—AMS to be just [20-30] per cent with a [0-10] per cent increment.
53. The OFT considers that the merged entity faces sufficient competitive constraints post merger given the number of alternative airlines serving LON-AMS (leisure) for the transaction not to give rise for concerns over unilateral effects on this route.

#### **LCY—AMS (business)**

The merger reduces the number of competitors from 3 to 2

54. When the merger completed in February 2008, it effectively created an AFKL monopoly for business travel on the LCY—AMS route - with a post-merger share of [90-100] per cent (increment [30-40] per cent) based on MIDT bookings data. Clearly, on this *prima facie* basis, the merger combines closest competitors and raises very serious unilateral effects concerns. (The merger also raises *prima facie* concerns over unilateral effects on the basis of a wider LHR/LCY—AMS market, where the post-merger share is [50-60] per cent with an increment of [0-10] per cent, on the basis of MIDT bookings.)
55. However, the pre-merger counterfactual should be adjusted to take account of imminent entry, in May 2008, by BA. BA's decision to enter LCY—AMS was made public in November 2007 and would have involved some pre-planning (for example, IATA slot conference). The merger was not announced until 24 December 2007. On the basis of the evidence available,

the OFT considers that BA is a new entrant on the route going forward, and did so independently of—rather than in response to—the merger.<sup>15</sup>

56. By including BA as a competitor, the merger might therefore best be viewed as reducing the number of competing airlines on LCY—AMS from 3 to 2, rather than from 2 to 1. The parties relied on the fact of the new BA service to argue that BA will provide sufficient competitive constraint on AFKL post-transaction, mitigating the possibility of unilateral effects post-merger.
57. Nevertheless, all else equal, and assuming significant entry barriers, a merger reducing the number of competitors from 3 to 2, rather than 2 to 1, still raises very serious *prima facie* unilateral effects concerns because of the assumption that the merger between any two of only three rivals combines *close* competitors, if not the *closest* competitors. Elimination of close competition in a differentiated market ordinarily suggests a *prima facie* post-merger incentive to raise price or reduce service.<sup>16</sup>
58. The table below gives an indication of the relative position of each of VLM, KLM and BA based on the latter's entry schedule and aircraft employed, and each merging party's pre-merger position, shown combined on a pro forma basis (see further, efficiencies, below).

<b>LCY to AMS</b>	<b>VLM</b>	<b>KLM</b>	<b>BA</b>	<b>KLM + VLM pre merger</b>	<b>Total</b>
Weekly frequencies	68	40	21	108	129
Seats per frequency	48*	48*	85-102†	-	-
Weekly capacity (seats)	3,264	1,920	1,955	5,184	7,139
Share of weekly frequencies	52.7	31.0	16.3	<b>83.7</b>	100
Share of weekly capacity	45.7	26.9	27.4	<b>72.6</b>	100

*Source:* airlines' websites. *Notes:* \*Fokker 50 †Avro RJ85, RJ100

59. It is apparent that while BA on these data matches — and indeed, slight exceeds — KLM's pre-merger weekly capacity, BA has only around 50 per

<sup>15</sup> Had BA's entry been in response to the merger, this would not have changed the analysis below, *ie.* the merger would still have raised unilateral concerns at peak periods on the LCY-AMS route.

<sup>16</sup> In other words, by combining the first and second choices for a substantial proportion of customers, this suggests high diversion ratios between the merging firms, which means that the merged firm would retain (recoup) enough of the passengers that it would have lost—in response to a pre-merger price increase or frequency reduction—to make such action profitable post-merger. This would hold true even if some passengers did switch to the remaining rival, who may also have the incentive to raise price.

cent of KLM's weekly frequencies. Even allowing for BA, therefore, the merger raises unilateral effects concerns because the merged entity will account for over 70 per cent of frequencies and capacity, with a substantial (around 25-30 per cent) increment. (A similar story emerges considering a wider LCY/LHR—AMS market where post-merger and after BA's entry the parties will account for 44 per cent of capacity, with an increment of 10 per cent, and 57 per cent of frequencies, with an increment of 22 per cent.)

The parties remain the only two serious alternatives for peak-time business travel

60. Notwithstanding the 3 to 2 characterisation given entry by BA, this appears substantially to *understate* the closeness of competition lost between the merging parties, seen through the lens of peak time travel (that is, between 06:00 and 10:00, and 16:00 and 20:00 according to ACL).
61. The opportunity to fly at peak times—indeed, to have the flexibility to chose from more than one flight at peak (for example, to arrive at the airport with a flexible ticket to catch the next flight, perhaps as a result of wishing to travel earlier or later than intended)—would appear to be a factor material, if not decisive, for much business travel by air, and the OFT has no reason to consider business travel on LCY—AMS as an exception.
62. The peak time schedules of each of the three competitors is as follows:
  - VLM – ten daily weekday services at peak times, comprising five departures between 07:45 and 09:45 and five departures between 16:40 and 20:00.
  - KLM—seven daily weekday services at peak times, comprising three departures between 07:45 and 09:25, and four departures between 16:55 and 19:45.
  - BA—two daily weekday services at peak times, comprising a single departure towards the end of morning and a single departure towards the end of evening peak (at 08:55 and 18:55), respectively.
63. As is apparent, BA's marginal peak-time presence suggests that it can at best be a very modest competitive constraint on VLM and KLM's pre-merger pricing at peak times, and therefore on AFKL post-merger. Its relative competitive insignificance for peak-time travel is reinforced by customer views. The responses of corporate customers contacted in the course of the investigation indicate they do not attribute much weight to

BA's entry on LCY—AMS. One customer expressly reports that BA's first service at 08:55 will not be sufficient to satisfy its demand for early morning departures and flexibility.

64. The merger is therefore best understood as eliminating closest competitors for peak-time travel and creating a near-monopoly at these times on the LCY—AMS route.

Peak-time slot constraints seriously limit BA's expansion and third-party entry

65. The first relevant question on countervailing constraints, therefore, is whether BA could replace the close competition between KLM and VLM by expanding its offer and increase its presence at peak times to replicate the seven daily schedules that KLM offered pre-merger (representing the increment in measures of concentration).
66. Although LCY, unlike for example LHR, is not a fully slot-coordinated airport (level 3) but rather is a schedule-facilitated airport (level two) in terms of its overall capacity (slot) utilisation across all times of the day/week, ACL told the OFT that the airport operates at full capacity at peak times, that is, between 06:00 and 10:00 and between 16:00 and 20:00, meaning that slots are no longer available at LCY at those times.
67. This entry barrier suggests that BA cannot credibly challenge AFKL's near-monopoly in peak times, **by acquiring additional slots for an expanded peak time schedule. Assuming therefore that BA retains the same overall number of peak slots at LCY, it is unlikely to be able to challenge AFKL** unless it were to slot-flex and sacrifice a significant number of slots it currently deploys to serve existing destinations from LCY other than AMS, such as Barcelona, Edinburgh, Frankfurt, Glasgow, Nice, Warsaw and Zurich.
68. However, the opportunity cost of slot-flexing would appear to be prohibitively high, explaining why BA chose to enter AMS with relatively small scale at peak times (one service in the late morning and one service in the evening)<sup>17</sup> and use a greater number of peak-time slots to serve other important business destinations. At present, the OFT has no evidence that BA would forego any flights to other destinations in favour of increasing its peak presence to AMS in response to a post-merger price increase or

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<sup>17</sup> BA operates four services a day on LCY-AMS. Only two of these services are flown at peak times.

frequency reduction, let alone to the degree required to replicate the competitive constraint (seven peak daily services) that KLM imposed on VLM.

69. Third party airlines' responses to OFT questions reinforce the information received from ACL, suggesting that obtaining new slots at LCY is difficult due to capacity constraints. One third party indicates that slot availability is the key issue for airlines wanting to enter LCY—AMS and LCY—RTM and that successful routes for business passengers generally involve high frequency, so that the minimum scale of entry to compete on a business-orientated route is high.
70. Accordingly, neither slot-flexing nor expansion by BA, nor entry by another third party airline, can be expected to be timely, likely and on a sufficient scale to replicate the competition lost between the merging parties. This conclusion stands even if the market were to be considered to comprise LCY and LHR, as the latter is the most congested of London airports, and is no less slot-constrained at peak periods than is LCY.

Existing BA and bmi services at LHR are insufficient to resolve concerns

71. While the OFT considers that services by BA and bmi from LHR—AMS are likely to impose a certain degree of competitive constraint on AFKL post-merger, the OFT has insufficient evidence to conclude that this, even in conjunction with other constraints, would be sufficient to challenge AFKL's near-monopoly at peak times from LCY and so to discipline AFKL's pricing and frequency plans on LCY—AMS post-merger. Indeed, although the OFT does not need to decide on this issue, the better view may be that constraints on business services between LCY and a destination such as AMS are asymmetric, in the sense that flights from LCY constrain flights from LHR without the reverse necessarily being true, or true to the same degree.

Buyer power is insufficient to discipline the merged firm

72. The parties indicate that a small number of large customers (the OFT understands three) account for [...] per cent of the parties' revenues on LCY—AMS and that these customers usually trade airlines off against each other, exercising a degree of buyer power, along with travel agents.

73. However, AFKL's near monopoly at peak times, insulated by the strength of the entry barriers posed by slot constraints, suggests limited prospects that buyer power by corporate customers, even in the form of annual corporate deals, would discipline the merged firm. Buyer power could not be wielded in the form of sponsoring peak-time entry onto the route, nor is self-supply an issue here. Rather, the mechanism would have to be one of leveraging multi-market buyer power across several routes which the customer used and which were more competitive than the LCY—AMS route post-merger.
74. In this regard, two corporate customers indicate to the OFT that they would be able to resist a 10 per cent price increase or equivalent worsening in non-price factors by the parties on LCY—AMS and LCY—RTM on account of the volume of air travel business they do with the parties on these and other routes. Conversely, two other customers say they could not resist such a price increase (but would switch some or all of their business elsewhere). One of these customers also tells the OFT, that until AFKL began operating on LCY—AMS, VLM was the only operator on two of its key routes (LCY—AMS and LCY—RTM) [Endnote 2]. It is reported that whilst VLM gave some discounts, they were not in line with the customer's expectations for a competitive route given the volume of its business with VLM.
75. Additionally, based on information provided by the parties and on customer responses to an OFT questionnaire, it appears that the parties' largest customers on LCY—AMS rely on the parties at least as much as the parties rely on them on other routes. That is, based on a comparison between (i) large corporate customers' share of the parties' revenue on LCY—AMS and (ii) the parties' share of these large customers' global travel expenditure, the parties' reliance on their large corporate customers on LCY—AMS seems proportionate to their large corporate customers' reliance on them elsewhere. Consequently, the basis of any power on the part of large customers is not clear—their threat not to use the parties on LCY—AMS seems no more credible than the parties' threat to increase fares on customers' other routes, given their apparent equi-proportional reliance on each other.
76. Overall, the OFT is not satisfied that the parties' main customers have buyer power to the extent that unilateral effect concerns could be mitigated. Further, four large customers indicate that they bi-laterally negotiate fares with the parties following periodic competitive tenders (annual or bi-annual).

Therefore, it is not clear to the OFT how, to the extent that large customers were to have any buyer power, it would protect smaller-volume customers, given such bi-laterally negotiated fares would not constitute a publicly available fare tariff from which smaller-volume customers could equally benefit.

77. Accordingly, buyer power alone and in conjunction with other countervailing constraints, does not resolve the OFT's unilateral effects concerns.

AFKL's efficiency claims do not resolve the OFT's concerns

78. AFKL submits that the transaction is likely to bring about material benefits to UK passengers: while AFKL does plan to rationalise frequencies on LCY—AMS to [...] per day, thus [...], it will however use larger aircraft (that is, [...]), such that overall capacity on the route (even during the peak time windows) is not necessarily affected. The parties further submit that AFKL expects to use the slots at LCY that are freed up by such rationalisation to enter new routes, though substantiated details of these were not given.

79. The OFT notes that on the most favourable basis claimed, the parties plan to operate no more than [...] daily frequencies between LCY and AMS. The OFT estimates that the parties therefore plan to operate at most [...] seats daily on LCY—AMS, whereas they currently operate [...] seats daily on this route. These plans therefore qualify not only as a reduction in pre-merger daily weekday frequencies from 19 to at most [...], but also at least a capacity reduction of [...] seats per day, on the most favourable estimate of the parties. These figures reinforce the OFT's concerns that the merger will give AFKL the incentive to reduce frequency and restrict capacity as a result of the merger. A contraction in capacity will very likely result in higher ticket prices due to the yield management systems employed in the airline sector, which automatically adjust prices upward as seats on a given flight become more scarce. Even for flexible tickets that do not apply to particular flights, AFKL can be expected to have the incentive to raise price because the merger combines, as noted, the only two providers with a substantial presence at peak times on this route.

80. In the absence of quantified and verifiable efficiency claims in terms of increased competition or the opening of entirely new destinations from LCY with the freed-up slots, both of which may be considered to benefit

passengers, the OFT has no basis to consider whether the substantial expected harm to business customers on LCY—AMS would be outweighed by benefits to customers on other routes. This approach is in line with the OFT's stated position in its *Substantive Assessment Guidance*, which states at paragraph 7.9 that '... to show that benefits in one market outweigh an expected substantial lessening of competition in another [the OFT] will require clear and compelling evidence.'

## Conclusion

81. Accordingly, the OFT believes that the merger may be expected to substantially lessen competition on the LCY—AMS route, with the potential for price increases and/or frequency reductions or other adverse impact on service quality for business travellers as a result of the merger. This conclusion does not change if, contrary to the OFT's indications on market definition, both LHR and LCY were considered on an aggregated basis at the London end of the O&D pair with AMS.

## LON—RTM

### The parties' activities pre-merger

82. Pre-merger, VLM operated a service from LCY—RTM and would have continued to do so, had the merger not gone ahead. Pre-merger, AFKL had not operated a service from LCY to Rotterdam. It had, however, historically operated two different services from London airports to RTM, namely:

- a service from STN to RTM through its subsidiary Transavia, and
- a service from LHR to RTM operated by KLM.

83. AFKL argues that the appropriate counterfactual to the merger is that it has decided independently of the merger to exit its services to RTM from each of STN and LHR, with the result that it should be treated as having no actual service competing with VLM's service on LCY—RTM. The question of the appropriate counterfactual to be applied is discussed below in detail in relation to the LON—RTM (leisure) overlap although the conclusions reached are also taken into account in the analysis of the LCY—RTM (business) route.

## **LON—RTM (leisure)**

84. Consistent with the OFT's approach to market definition in this case, as explained in paragraphs 37 - 39 above, the OFT has considered all London airports to be in the same market for leisure passengers.
85. Pre-merger, AFKL operated services from two London airports to RTM: Transavia from STN and KLM from LHR. VLM operated flights from LCY to RTM. Given that no other carriers operate direct services to RTM from any other London airport, the merger *prima facie* (and subject to the correct counterfactual analysis, as discussed below) leads to a merger to monopoly on the LON—RTM route.
86. It is possible that the loss of a competitive constraint through actual competition could, in any event, be adequately balanced by the likelihood of new entry.<sup>18</sup> However, there are a number of reasons why, in relation to LON—RTM, entry may not be regarded as likely, timely and sufficient such as to mitigate concerns. First, only [...] per cent of KLM's LHR—RTM traffic actually comprised leisure passengers, such that entry at one of the other London airports (STN, LTN or GTW) intended to serve leisure passengers may appear less viable. Second, it is reasonable to consider, given the precise nature of the route, that the significant majority of VLM's passengers on its LCY—RTM route will be business, rather than leisure, passengers. Third, it is notable that Transavia, which was previously operating leisure services from STN—RTM, decided to exit the market (see paragraphs 92 - 94 below).
87. The above considerations raise significant questions about whether entry targeted specifically at leisure passengers would be likely given the demand profile on the LON—RTM route. Although it has not needed to conclude on this point, the OFT considers that entry would be unlikely to constrain the merging parties post-merger on LON—RTM when testing against pre-merger conditions, and hence it is appropriate to examine the parties' arguments on the correct counterfactual.

## Counterfactual

88. The OFT's general approach is that it relies on pre-merger conditions as the appropriate proxy for the counterfactual and will test the competitive impact of any transaction against such a standard before proceeding to consider whether another counterfactual should be substituted. In general, where the merger raises no concerns relative to pre-merger conditions, nothing will turn on the OFT's adoption of its default counterfactual of pre-merger conditions<sup>19</sup> and there will be no need to consider the detailed factual questions that arise under substitute counterfactuals that, for example, the failing firm defence engages.
89. However, where the merger does raise concerns relative to the pre-merger situation, the OFT is slow to clear a transaction based on the 'inevitability' of exit of the target (or indeed, as in this case, the acquiring) business. That is why, where a seller wishes to exit a market because the relevant business is failing or distressed, the OFT will not lightly depart from judging the impact of such a sale as against pre-merger conditions, and will only do so when it has sufficient compelling evidence that exit is inevitable, in line with the first two criteria of the failing firm defence.
90. When applying its counterfactual analysis, the OFT is mindful not merely of whether the target firm (or, where relevant, the acquirer) would exit the market, but also of whether it had any plans to re-enter the market in the foreseeable future. To the extent that there is evidence that the exit from the market may be temporary,<sup>20</sup> this will not result in a change to the pre-merger counterfactual.
91. As discussed above, in this case the pre-merger position clearly does raise competition concerns given that VLM will become the only carrier flying

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<sup>18</sup> See in this respect the OFT's analysis of the competition impact of new entry in its decision on the anticipated acquisition by easyJet Airline Company Limited of GB Airways Limited.

<sup>19</sup> A rare exception to this will be where the OFT has concerns that the merger eliminates an important potential entrant—including entry by acquisition of the unique assets of target—but for the merger. The evidentiary cautions expressed by the OFT in BSkyB/ITV would apply in such cases. See further paragraphs 108 to 109 in relation to the analysis of potential competition in relation to LCY—RTM.

<sup>20</sup> In the case of a retail merger, for example, a temporary absence from the market might arise where there was a gap between the time at which a party surrendered a lease or closed an outlet either for refurbishment or permanently, and the time at which it intended to recommence trading—potentially from a new location—within the same geographic market.











































