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Chairman
Channel Island Competition and Regulatory Authority
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30th September 2016

Dear Mr O'Higgins

Flybe / Blue Islands – A better deal for Channel Islanders?

We are in receipt of your open letter of 19th September and wish to assure you and all Channel Islanders that Blue Islands is fully aware of the importance of air links to the Channel Islands and by extension is acutely aware of the interest that Channel Island residents, businesses and all other associated stakeholders have in these services and any changes to them.

Unfortunately, there remains a great deal of misunderstanding about the structure of the Franchise Agreement between Blue Islands and Flybe amongst Channel Islanders. To date, our efforts have not been assisted by the continued misinterpretation of the agreement by local media representations and commentators.

For example, we note from your communication that one commentator has referred to the Franchise as the "the merger" which it certainly is not. But more importantly, we are disturbed by the premise of the fourth paragraph of your letter in which you state you are "*challenging Flybe/Blue Islands to set out to its [sic] customers (many of whom have no choice but to use its [sic] services) how the reduction in competition through two airlines cooperating rather than competing has delivered a net benefit to users*". This implies that CICRA regards Flybe and Blue Islands as constituting a single entity (which they clearly do not), and that it is of the view that the Franchise arrangement has reduced competition (which we do not accept) and that Flybe and Blue Islands are not competing (which is not the case). We reserve our position on whether an open letter is the appropriate forum for CICRA publically to state these views.

In the light of this, Blue Islands needs to further inform our customers how this agreement works in practice and most importantly how it will impact on and be of benefit to our islands. For that reason, we now take this opportunity to re-iterate the structure and benefits of the Franchise Agreement between Flybe and Blue Islands and address the questions set out in your above referenced letter.

Understanding the franchise agreement between Flybe and Blue Islands

The British Franchise Association defines business format franchising as

“the granting of a license by one person (the franchisor) to another (the franchisee), which entitles the franchisee to own and operate their own business under the brand, systems and proven business model of the franchisor”¹

This description encapsulates the agreement in place between Flybe and Blue Islands with the key points of the arrangement as detailed below:

- The ownership structure of Blue Islands is unchanged and the company remains 100% privately owned by a Channel Islands resident.
- All Blue Islands services are operated on Blue Islands aircraft by Blue Islands crew. Flights are however operated under the Flybe brand with Blue Islands crew wearing the Flybe uniforms and the process of repainting Blue Islands aircraft in Flybe livery being underway.
- Blue Islands retain complete operational control of its scheduling, including which destinations to fly to, which aircraft to deploy on each route, how many flights to operate per day and at what times to operate the flights
- Blue Islands set its own fares on every single Blue Islands operated flight. Flybe have no influence on Blue Islands pricing and no discussions take place between the two operators on the fares to be offered.
- Blue Islands may leverage a separately partitioned application of the robust and feature-rich systems of Flybe to distribute and sell seats on all Blue Islands operated services. Key to this is that Blue Islands retain all commercial risk of their operated services, despite the fact that they are operated under the licenced brand of Flybe.

The Inter-island route

Competition

This letter is not the place to set out a detailed analysis of competition theory or competition law, but we would observe that neither assumes that franchising is in itself anti-competitive. Within this Franchise environment, Blue Islands retain complete and independent control of its schedules and fares while its own objectives in reaching commercial decisions regarding capacity, flight timing and the prices charged are unchanged. The same is true of Flybe. Within the Franchise agreement there is no way whatsoever in which either Flybe or Blue Islands is motivated to do anything other than sell its own inventory, and certainly no basis on which to infer that either operator would no longer strive to achieve the highest possible market share through both pricing and schedule.

Blue Islands has revenue aspirations to meet its costs which include aircraft, maintenance and engineering, salaries of over 100 employees, ground handling, fuel, rent, administration and IT etc. These are costs which need to be met and therefore a passenger booking a Flybe operated service is of no benefit to Blue Islands and is seen by it as a lost revenue opportunity. Blue Islands of course

¹ <https://www.thebfa.org/about-franchising>

seeks to maximise passenger volumes on its operated services. Flying with another airline, including Flybe does not help Blue Islands achieve these targets.

With unchanged control over the key commercial considerations of capacity/schedule and price and maintenance of the same objectives as were in existence before the Franchise agreement any suggestion that Blue Islands and Flybe no longer compete on this route is simply not true. It is important that respective authorities and regulators alike deal directly and separately with each entity as separate commercial concerns.

Capacity

From 2nd January 2016 through to 18th September 2016, 4 out of every 10 seats offered between Guernsey and Jersey on Blue Islands operated services have flown empty. Blue Islands operates up to 6 flights per day each way between the islands, offering a total capacity of 552 seats.

Despite the abundance in seats, we hear calls from various corners for Aurigny to return to this route. Were this to take place we would inevitably return to the position whereby we estimate each operator would lose over £1 million per annum for no gain whatsoever.

Blue Islands would also wish to highlight the change to the Flybe licence to operate between the islands made late in 2015. Historically, Flybe were restricted to selling only 10% of physical seats on the aircraft used to facilitate their triangular services from Exeter and Birmingham for point to point inter-island travel. This restriction had been imposed in recognition of the finite inter-island market and need to protect the committed market operators offering the vast majority of capacity on the route. This restriction was removed allowing Flybe to sell as many seats as they desired for point to point travel, significantly increasing the number of seats that they are able to offer in the market.

The letter received on the 19th September notes that Channel Islanders desire choice "*where that is feasible*". Blue Islands echoes this sentiment and would draw CICRA's attention to the extraordinary protections afforded on the Guernsey to London Gatwick services as evidenced by the November 2013 Air Transport Licensing (Guernsey) Law, 1995 Policy Statement. On the largest volume route from Guernsey it is understood that competition on a route does not by default override the need for a route to be operated in a manner which is sustainable over the long term and offers customers continuous reliable services in what are very small markets.

So there is already a recognition that certain market sizes are too small to sustain two operators and Gatwick, the largest route (over twice the size of the next largest route) from Guernsey is being protected from any competition. Yet on a smaller route that CICRA previously recognised could not sustain capacity of two operators (evidenced by its decision to allow the Blue Islands and Aurigny codeshare) we see pressure to recreate unsustainable operations.

It is also clearly observed that Aurigny, as owned and operated by the States of Guernsey, operates exclusive monopolies on every one of its seven direct routes from Guernsey to the UK currently available for sale through aurigny.com, all of which are licensed by the States of Guernsey. Inter-island remains the only direct route from Guernsey where competition between two operators exists. Blue Islands is the primary dedicated operator, with committed fleet specifically for this route. Flybe operate the route as part of a 'wrap route' on Exeter and Birmingham with aircraft landing in Guernsey or Jersey from the UK to pick up additional passengers before moving to the next island to pick up

further passengers. It must be understood that the viability of additional operators on any route is at the detriment of the sustainability of the existing services that are enjoyed. In particular, the high frequency, year round services provided by committed locally based operators (and most importantly with locally based aircraft) are jeopardised by the introduction of additional capacity from another carrier.

If the States of Guernsey and Jersey were to conclude that there is a need for a level of capacity on the inter-island route well above that which can be commercially justified, then Blue Islands would be willing to enter into discussion with both parties on how we could facilitate this additional capacity, provided that the resulting losses were to be underwritten. Blue Islands contend that this approach, as opposed to the re-introduction of Aurigny to the route, would offer the best value for money to Channel Islanders.

Fares

Operators on the inter-island route are often criticised for the fares charged given the short flight duration. Whilst the cost of fuel in the Channel Islands is the highest on our network, the fact that an inter-island flight is only a short distance is only a small factor on the overall cost to Blue Islands of operating an inter-island flight. The charges at Guernsey and Jersey airports are the highest on our network and consume approximately one third of the current average fare on an inter-island flight. Another third is attributable to various third party suppliers such as ground handling and fuel and other direct operating costs. The final third contributes towards aircraft, salaries, engineering, maintenance, insurance, rent, administration and infrastructure.

Blue Islands shares entirely the desire for lower cost services. With effect from 1st April 2016, Guernsey airport increased the security fees charged for every passenger arriving or departing the airport by 21% from the charges levied over the prior 12 months. This significant cost increase occurred against a Guernsey RPI of 0.5% for the 12 months to 31st March 2016 and is just one example of the ever increasing cost challenges we continue to face. Despite this, fares on inter-island services start from £39.99 one-way, the same as in 2014 and still include free baggage and ticket changes (fare difference may apply) as standard. If these airports were viewed as key infrastructure, as opposed to revenue generators, charges could be reduced and they could become an economic enabler, with lower fares passed on to the consumer and driving the economies of Guernsey and Jersey.

Blue Islands is entirely open to a discussion with the States of Guernsey and States of Jersey on how lower fares could be offered on the inter-island route should there be a contribution made to the operating costs of the route. Such a contribution could be made through a reduction in airport fees or an explicit subsidy towards the costs of operation that would be passed on to consumers.

Response to specific points raised

'Passengers will benefit from seamless connections'

Punctuality

Again, it should be stressed that the operations of Blue Islands and Flybe remain independent with both airlines employing their own flight crew, procuring their own aircraft and setting their own schedules. The Franchise has no impact on either operator's punctuality performance.

The issues faced by Blue Islands over the summer with unprecedented levels of weather disruption being compounded by unforeseeable technical issues and the failure of a lessor to deliver a further aircraft at the agreed time are well documented and have been covered extensively in the local media.

Blue Islands has taken robust steps to address these issues, including significant investment in procuring a long term standby aircraft from a third party operator to restore resilience to the Blue Islands fleet. This has allowed Blue Islands to return to historic levels of reliability with 93% of inter-island flights departing within the industry standard 15 minutes of scheduled departure time between the 8th August and 7th September (inclusive). This figure rises to 96% when excluding those services that were delayed due to weather conditions outside of Blue Islands' control.

The open letter received on 19th September states that *"one in every four flights is delayed by more than 15 minutes"* sourced from the latest available March 2016 CAA statistics. Whilst Blue Islands is unsure exactly how this figure was reached, we do not recognise this statement from our own known performance which confirms that 86% of flights across the network departed within 15 minutes of their schedule time in March 2016. In any event, Blue Islands would wish to point out that the sample period used of March 2016 was before the Franchise commenced and so the Franchise certainly played no part in the stated performance.

Connecting to the wider Flybe network

The Franchise has allowed Channel Island residents to access a wide array of destinations that are not operated directly from either Jersey or Guernsey by connecting with the wider UK and European Flybe network via Southampton and London City airports. This enhanced connectivity has already proven popular with both Island residents and visitors to the Channel Islands alike, with thousands of passengers on Blue Islands operated Guernsey to Southampton and Jersey to Southampton services connecting on to or from another point on the Flybe network since the Franchise commenced.

These passengers benefit from the Franchise in a number of ways:

- 1) Bookings can be made through a single reservations system, as opposed to the historic need to book one flight through Blue Islands' reservation system and then the second through Flybe's
- 2) Baggage is checked through to final destination
- 3) In the event of disruption to either of the flights within the booking, passengers can rest assured that they will be re-accommodated to the next available service entirely free of charge. This stands in stark contrast to a situation using a point-to-point model where a passenger books two separate flights with different airlines as there is no obligation on either airline to compensate or accommodate the passenger in the event of a missed connection.

- 4) When booking a through ticket from the Channel Islands to a UK airport in order to then connect to another service there are significant savings in the UK Government Air Passenger Duty (APD) tax. Channel Islanders are able to save up to £26 (APD) per person on a return connecting itinerary as a result of the Franchise agreement

'Lowest possible fare options'

Frequent flyer scheme

Blue Islands' former frequent flyer scheme Bonus Blue was phased out prior to the commencement of the Franchise agreement (as was communicated with all members of this reward scheme). Blue Islands is pleased to now offer all passengers on our services the opportunity to earn AVIOS points which can be redeemed against a vast array of goods and services, including but not limited to Blue Islands and Flybe operated flights. Contrary to the implication of the letter dated 19th that the frequent flyer scheme has simply been removed, it has in fact been replaced by an offering which is superior in many ways.

'Ticket Customisation'

Inter-island

The demand for flexibility on the inter-island market has always been far in excess of any other route on the Blue Islands network. It is for this reason that the old Blue Islands product which included unlimited name and itinerary changes (subject to fare differences) was so valued by users of this service, particularly the business community.

In recognition of the importance of this flexibility, the decision was taken to continue to offer this product type within the Franchise environment. The intention to maintain this flexibility on all inter-island ticket types has been stated publically by Blue Islands on numerous occasions.

Routes between the Channel Islands and the UK

There is no doubt that the enhanced ticket customisation options made possible through the Franchise agreement have allowed Channel Islanders to access far lower fares than were available before the Franchise was implemented on Blue Islands operated services.

Guernsey residents are now able to travel on Blue Islands operated services between Guernsey and Southampton from as little as £29.99 one-way compared to the lowest available fare before the Franchise of £49. On services between Jersey and Bristol it is now possible to travel from £44.99 one way compared to the lowest available fare of £59 before the Franchise was implemented.

'Time Saving Business Travel'

Punctuality

Please see above '*Passengers will benefit from seamless connections*' comment.

In addition, we would re-iterate that since the Franchise has been launched thousands of passengers are taking advantage of the ability to connect through Southampton airport to other UK destinations as well as mainland Europe for both business and leisure.

Credit Terms

The provision of credit terms is of course entirely at the discretion of any given business and far from a mandatory offering. In fact, it is not common place to offer such credit terms within online transactional businesses. Furthermore, in becoming a Flybe franchise partner, we adopted Flybe's product specifications, terms and conditions which do not include the provision of extended credit terms. This is key to ensuring our businesses operate as efficiently as possible in order to continually offer our most competitive (lowest priced) fares (by way of continually striving to maintain as low a cost base as possible). We now, together with Flybe offer payment terms in line with the vast majority of this industry.

Other Franchise benefits

Promotion of the islands

Flybe's marketing power, including a significant email database, substantial investment in traditional media and advanced use of digital marketing can now be fully leveraged in the promotion of Blue Islands services and by extension the Channel Islands. The scope of Flybe's reach is far greater than anything that Blue Islands could achieve outside the Franchise arrangement.

The Franchise therefore allows the Channel Islands to be promoted to a new wider audience with obvious benefits to local economies in each island through enhanced ability to attract leisure visitors and by providing improved ways in which business travellers can access both Guernsey and Jersey through the connecting itinerary options outlined above.

Furthermore, the promotion and marketing capability that Blue Islands is now able to leverage is a fundamental reason why we have been able to justify the introduction of the recently announced Guernsey to Cardiff service from the summer of 2017. There is a huge amount of financial risk in any new route launch, particularly where it is to an airport where the operator is not already established (as is the case with Blue Islands and Cardiff) and so has no industry connections with travel agents to drive volume nor established marketing channels. As a Franchise partner of Flybe, the new Guernsey to Cardiff service will be distributed and promoted alongside existing Flybe operated services from Cardiff. Beyond the intermediaries, direct to consumer marketing is also greatly improved with, for example, the full Flybe Cardiff catchment area email database being available for promotion of the new Guernsey service.

Blue Islands would not be seeking to commence Guernsey to Cardiff services without the promotional bandwidth afforded by our Flybe Franchise arrangement. The Franchise significantly broadens the scope of new route destinations that Blue Islands are able to consider.

Distribution of flights offered

A significant proportion of air travel, within both the leisure and business sectors, continues to be facilitated through various intermediaries. These intermediaries include online travel agents and booking tools (such as Expedia and Opodo), large corporate travel management companies and also Global Distribution System used by travel agents across the globe to book flights. Establishing a presence across all of these intermediaries is both resource intensive and often extremely expensive.

Through the Franchise, Blue Islands services become available to view and book across every intermediary platform and become visible to every agent where Flybe's own flights are visible. As with the enhanced marketing and promotion capability outlined above, this improved distribution will increase Blue Islands ability to attract visitors to the islands with a net benefit through the economies of both islands.

Preferential rates with other partners

Flybe has a significant array of preferential rates that are offered to customers on services such as car hire and hotel accommodation through third party partners. Again these rates are far superior to anything that Blue Islands would be able to secure in isolation with our relatively low volume throughput. All of these preferential rates and arrangements are now available to all passengers travelling on a Blue Islands operated flight.

Mobile experience

Blue Islands had no mobile platform prior to the introduction of the Franchise. The cost of implementing this functionality had been assessed and found not to be commercially viable. The Franchise allows for Blue Islands passengers to use the Flybe mobile infrastructure providing a streamlined mobile booking experience.

Securing the long term sustainability of Blue Islands as an operator

The Franchise Agreement provides a significant increase in security to Blue Islands' long term commercial sustainability as Blue Islands forecast a substantial increase in passenger numbers, and therefore revenue under the Franchise coupled with numerous cost savings.

The importance of this security should not be underestimated for all users of the Channel Islands' air transport services who rely on Blue Islands for connectivity to the UK and between Guernsey and Jersey.

Blue Islands commitment to the islands

Blue Islands maintains that its commitment to the Channel Islands has been and continues to be demonstrated in the following key respects:

- 1) Blue Islands has served the islands for over 10 years.
- 2) Over the company's history, significant investment has been made in the fleet in order to offer a wider range of destinations and an increased number of seats to Channel Islanders and potential visitors. From our origins of operating 15 seat aircraft between the islands and to mainland UK the fleet now consists of 3 46/48 seats ATR42 aircraft and one 66 seat ATR72 aircraft. This investment continues, with Blue Islands taking delivery of a second 68 seat ATR72 aircraft in the coming weeks.
- 3) Blue Islands has a history of launching new routes from the islands such as direct services to Amsterdam, Paris Charles de Gaulle, Zurich and Geneva. In every case, Blue Islands has taken significant financial risk in an attempt to enhance the range of services available to islanders and in the majority of instances suffered significant financial loss as a result

- 4) Blue Islands continues to invest in route development from the islands, most recently demonstrated by the announcement of a direct service from Guernsey to Cardiff commencing in the summer season of 2017.
- 5) Blue Islands has historically had a fleet of 5 aircraft, and will do so again once the next ATR72 aircraft referenced in point 2 above has been delivered, however only 4 of these aircraft are scheduled to operate at any one time. There is therefore a significant asset that Blue Islands does not utilise for any revenue generative activity. This is done purely to allow Blue Islands to have a contingency in place whereby should there be a technical fault within the fleet there is replacement aircraft on hand to take over. In doing this, Blue Islands again shows that the importance of reliable air links is understood and demonstrable investment in securing this reliability is taking place. It should also be noted that this arrangement with 20% of the fleet never being scheduled to fly is extremely rare within regional aviation. Typically, you would see one spare aircraft in 12 (8%).
- 6) 100% of this investment (upward of £45m to date) has been privately funded, no direct funding has been received by either the States of Guernsey or Jersey. To disregard this level of private investment runs contrary to the words of Guernsey politicians in questioning whether or not "Guernsey is open for business".

With the above in mind, Blue Islands fails to see how there can be any doubt of the level of commitment we have to our islands. We would also point out that, for all flights operating to or from Guernsey (including inter-island), Blue Islands operates in a licensed environment.

Conclusion

We trust this letter serves to explain how Flybe and Blue Islands operate independently, albeit under common branding. Consumers can choose between flights operated by Flybe and those operated by Blue Islands which are independently scheduled and priced. Each party is incentivised to gain maximum market share for itself. We do compete with each other, vigorously, and there is no reduction in competition. We also hope we have further clarified how consumers benefit substantially from the Franchise arrangements, including features from which they could not benefit without the Franchise being in place.

For and on behalf of
Blue Islands Limited

Yours sincerely



R J Veron
Chief Executive Officer