

**British Airways Plc  
and  
CityFlyer Express Limited**

A report on the proposed merger



COMPETITION COMMISSION

# **British Airways Plc and CityFlyer Express Limited**

A report on the proposed merger

**Presented to Parliament by the Secretary of State for  
Trade and Industry by Command of Her Majesty  
July 1999**



## **Members of the Competition Commission as at 28 April 1999**

Dr D J Morris<sup>1</sup> (*Chairman*)  
Mr P G Corbett CBE (*Deputy Chairman*)  
Mrs D P B Kingsmill (*Deputy Chairman*)  
Mr H G C Aldous  
Professor J Beatson QC  
Mr R D D Bertram<sup>1</sup>  
Mrs S E Brown  
Professor M Cave  
Mr A T Clothier<sup>1</sup>  
Mr R H F Croft CB  
Mr C Darke  
Mr N H Finney OBE  
Professor P A Geroski  
Mr D B Hammond  
Miss J C Hanratty  
Mr C E Henderson CB  
Mr D J Jenkins MBE  
Mr R Lyons  
Mr P Mackay CB  
Mrs K M H Mortimer  
Mr R J Munson  
Professor D M G Newbery  
Dr G F Owen  
Mr M R Prosser  
Mr A J Pryor CB<sup>1</sup>  
Mr R A Rawlinson  
Professor J A Rees  
Mr T S Richmond MBE  
Mr J B K Rickford  
Dame Helena Shovelton DBE  
Mr G H Stacy CBE  
Mr J D S Stark  
Professor A Steele

Miss P A Boys (*Secretary*)

---

<sup>1</sup>These members formed the Group which was responsible for this report under the chairmanship of Dr D J Morris.

## **Note by the Department of Trade and Industry**

In accordance with section 83(3) and (3A) of the Fair Trading Act 1973, the Secretary of State has excluded from the copies of the report, as laid before Parliament and as published, certain matters, publication of which appears to the Secretary of State to be against the public interest, or which he considers would not be in the public interest to disclose and which, in his opinion, would seriously and prejudicially affect certain interests.

**The omissions are indicated by a note in the text or, where space does not permit, by the symbol ✂.**

# Contents

	<i>Page</i>
<b>Part I—Summary and Conclusions</b>	
<i>Chapter</i> 1	Introduction and Summary ..... 3
2	Conclusions ..... 6
<b>Part II—Background and evidence</b>	
3	The parties and background to the merger ..... 57
4	Regulation and other constraints on air services ..... 71
5	The market for air services ..... 95
6	Views of the main parties ..... 151
7	Views of third parties other than regulatory bodies ..... 181
8	Views of regulatory bodies ..... 202
	List of signatories ..... 214
<i>Appendices</i>	(The numbering of the appendices indicates the chapters to which they relate.)
1.1	The reference and background ..... 215
3.1	Brymon: trading record ..... 218
3.2	BA: balance sheet summary ..... 219
3.3	BA: profit and loss summary ..... 220
3.4	BA: facilities used by CityFlyer ..... 221
3.5	Correspondence relating to Virgin Atlantic's bid for CityFlyer ..... 226
4.1	The freedoms of the air ..... 234
4.2	Bermuda 2 ..... 236
4.3	Extracts from the EC slot regulation ..... 238
4.4	Gatwick Scheduling Committee voting rights ..... 244
4.5	Analysis of Gatwick slot allocations ..... 245
4.6	Background to the development of Gatwick ..... 246
5.1	Parallel scheduled routes operating from Heathrow and Gatwick ..... 249
5.2	Classification of fares ..... 251
5.3	International operators at Gatwick and Heathrow, 1996 to 1998 ..... 253
5.4	BA calculations of network contribution ..... 255
5.5	Estimates of CityFlyer network contribution ..... 258
5.6	Fare developments on sample UK routes ..... 259
5.7	Airlines included in CAA hub analysis ..... 260
5.8	Share of passengers travelling via major European hubs to/from UK regional airports ..... 261
5.9	Peak week slot statistics, summer 1999 ..... 262
5.10	Virgin Atlantic slot bids, allocation and use at Gatwick and Heathrow ..... 263
6.1	Note submitted by BA on its potential response to the loss of the CityFlyer franchise—example scenario ..... 265
	Glossary ..... 267

Part I

# **Summary and Conclusions**

# 1 Introduction and Summary

## Introduction

1.1. On 20 January 1999, the Secretary of State referred to the Monopolies and Mergers Commission (MMC) the proposed acquisition of CityFlyer Express Limited (CityFlyer) by British Airways Plc (BA). The terms of reference are set out in Appendix 1.1. Section 45 of the Competition Act 1998, which came into force on 1 April 1999, dissolved the MMC and transferred its functions to the Competition Commission. Those functions are to be carried out by reporting panel members of the Competition Commission. Members of the MMC immediately before the coming into force of section 45 became members of the reporting panel. Thus the investigation was carried out in part by the MMC and in part by the Competition Commission, and this report is submitted by the latter. For convenience we use the term 'Commission' to refer to the Competition Commission or the MMC as the context requires.

## Summary

1.2. In terms of total passengers carried, BA is the ninth largest airline in the world but it carries more passengers on international services than any other airline, operating to 167 destinations in 87 countries. BA's traditional base is London Heathrow Airport (Heathrow) where it provides a network of long-haul and short-haul services interconnecting at the airport in a so-called 'hub' operation. Because of growing congestion at Heathrow, it has, since the early 1990s, developed a similar hub operation at London Gatwick Airport (Gatwick) making use of franchisees to operate services on many of the short-haul routes in its network. It also provides low-cost, no-frills, air services from London Stansted Airport (Stansted) through its subsidiary Go-Fly Limited (Go).

1.3. CityFlyer was set up by its managers in 1991 with backing from four institutional investors. It became BA's first franchisee at Gatwick in 1993. It now operates services from Gatwick to 12 destinations in the UK, Channel Islands and elsewhere in Europe with aircraft painted in BA's colours, using BA's cabin designs and crew uniforms and operating to BA's service, maintenance and safety standards. It remains an independent company able to set its own schedules and fares, but in practice virtually all its flights operate under the franchise and at fares virtually identical to those of BA. In terms of the number of flights operated, CityFlyer is the second largest airline operating at Gatwick, after BA, and it has been profitable in every year of its operation except the first. The proposed acquisition by BA came about because CityFlyer's institutional shareholders wished to sell their shares to realize their investments.

1.4. To assess the effect of the merger on competition, we have considered whether services from Heathrow, Stansted, Luton and London City airports are substitutable for those from Gatwick. We have concluded that this is generally not the case as far as passengers transferring between flights at Gatwick are concerned. But there is evidence of growing

competition for these connecting passengers from airlines offering interconnections at major hubs elsewhere in Europe or further afield. To that extent, services from Gatwick operate in a much wider market. For point-to-point travellers starting or finishing their air journeys in London we consider that Gatwick services are subject to substantial competition from Heathrow. There is also increasing competition from the other London airports. This is currently less evident in the business sector than the leisure sector but there is at least some overlap in both sectors and we would expect this to increase.

1.5. In considering the consequences of the merger for the public interest we looked first at the loss of competition between CityFlyer and BA on the routes served by both airlines—the ‘overlap routes’. We then looked at the wider effects of BA’s acquisition of CityFlyer’s substantial holding of take-off and landing slots, both in terms of the extra flexibility that it gave BA to ‘shuffle’ slots between services and the possibility of foreclosure of further competition at Gatwick. We also went on to address concerns put to us that the merger would reduce other airlines’ access to the noise and night movement quotas that govern night-time activity at Gatwick and that BA’s influence over the allocation of ancillary facilities at Gatwick would be increased to the detriment of competitors.

1.6. We also considered what would happen if the merger were not to proceed. As CityFlyer’s shareholders wished to sell the business it seemed unlikely that the status quo would be maintained; and we took the view that no single scenario from the range of other possibilities was sufficiently likely to arise to be regarded as the probable alternative to the merger. However, there were certain features common to most of the possible scenarios. It was likely that there would be a degree of competition for BA that would not exist if the merger were to proceed; it was unlikely that BA would acquire control of CityFlyer’s slots and it would not therefore be in a stronger position vis-à-vis its competitors; and it was unlikely that all of CityFlyer’s current services would be maintained. We considered that these were outcomes that could be expected to arise if the merger were not to proceed and that we should take them into account.

1.7. We concluded that the merger would have little effect on the level of competition on the overlap routes. Some of those routes were well served by other airlines from one or more London airport and, in the case of services to Newcastle, there was competition from high-speed rail. These routes would remain competitive. Others were thinner routes and we considered it unlikely, in any event, that CityFlyer’s services on these routes would be maintained if the merger were not to proceed.

1.8. We considered the effect of BA’s acquisition of CityFlyer’s slots to be more significant. It would strengthen BA’s competitive position by increasing its flexibility to reorganize its schedules and services. This would enable it to respond more rapidly than its competitors to new opportunities or competitive threats and to absorb into its network slots which airlines with a smaller portfolio of slots and services would find it difficult to use. The merger would also preclude competition for BA at Gatwick that might be expected to arise in the absence of the merger.

1.9. On the other hand, we noted that there was at least some scope for BA’s competitors to build up a portfolio of usable slots at Gatwick though this was likely to be a gradual process. BA was also subject to competitive pressures from airlines operating from other London airports and, in the case of its connecting passengers, from the hub operations of its major European and US competitors.

1.10. We found that the merger would have certain benefits to the public interest. In particular, we consider that there would be a greater diversity of routes which could profitably be operated if the merger were to proceed than would otherwise be the case. The

merger would also be of some benefit in preserving coordinated transfer arrangements for more connecting passengers at Gatwick than would otherwise be the case.

1.11. Taking into account the generally increasing level of competition in BA's markets, we find that the detriments and benefits of this merger are very finely balanced. But our judgment is that, on balance, the merger may be expected to operate against the public interest primarily because of its effects on competition, with the result that fares for air services would be higher than would otherwise be the case.

1.12. We have considered and rejected the option of prohibiting the merger. We believe that this would be disproportionate to the detriments, that it could have adverse consequences in terms of a loss of route diversity and that the detriments could be remedied in other ways.

1.13. We consider that the detriments can best be remedied by giving BA's competitors more scope to access the slots becoming available at Gatwick over the next five years.

1.14. To this end, we have recommended that the share of slots at Gatwick used by BA and its subsidiaries should be capped at a level of 41 per cent of available slots. This level was determined on the assumption that the share of slots used by BA's franchisees for services licensed by BA is no more than 5 per cent. Any usage above that level should be compensated by an equivalent reduction in BA's usage. To ensure that the appropriate capacity remains available to BA's competitors in the peak operating periods, we have also recommended that there should be a cap of 70 per cent on the share of slots available in any one hour held by BA and its subsidiaries and franchisees and a cap of 65 per cent on their share of slots in any two-hour period.

1.15. This would not require BA or its subsidiaries or franchisees to divest any of the slots they have been allocated for the summer 1999 season; and by the same token, would not require the withdrawal of any of their current services.