

2 Conclusions

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The reference

2.1. On 20 January 1999 the Secretary of State for Trade and Industry made a reference to us under the merger provisions of the Fair Trading Act 1973 (the FTA) concerning the proposed acquisition of CityFlyer by BA. The terms of reference are set out in full in Appendix 1.1. The Department of Trade and Industry press notice said that the reference had been made, in accordance with the advice of the Director General of Fair Trading (DGFT), because the merger raised competition concerns in respect of the market for air services.

The companies involved

British Airways Plc

2.2. BA traces its origins back to the first commercial international flight in 1919 between Hounslow and Le Bourget. It was nationalized in 1940 and remained in the public sector until privatization in January 1987. Heathrow had been BA's operational base since 1946 but, in 1988, it acquired British Caledonian Group plc (BCal), and its Gatwick-based airline subsidiary, which had run into financial difficulties. In 1992 it acquired Dan-Air, also based at Gatwick, and these two acquisitions formed the platform for a significant expansion of BA's operations at Gatwick. Other acquisitions in recent years have included Brymon European Airways Limited (Brymon); a German airline from which BA established Deutsche BA; a 76 per cent interest in Air Liberté, formed from two French airlines; and a 25 per cent interest in the Australian airline Qantas. In 1998, BA established a low-cost no-frills airline (see glossary), operating from Stansted through its subsidiary Go.

2.3. BA is the ninth largest airline in the world in terms of total numbers of passengers carried. A number of US airlines, in particular, are larger. However, BA currently operates to 167 destinations in 87 countries and carries more passengers on international flights than any other airline. At Heathrow, which remains its most important operating base in terms of numbers of flights and passengers carried, BA provided a network of 50 short-haul and 39 long-haul services in summer 1998 interconnecting at the airport in a so-called hub operation (see paragraph 5.90). But congestion at Heathrow has prevented it from expanding this operation as it would wish and it has therefore developed a second hub at Gatwick from which it offers services to 41 short-haul and 34 long-haul destinations.

2.4. In common with other major airlines, BA has entered into a number of franchising arrangements with smaller airlines in order to extend its network of services, particularly to

lower density routes. It now has ten franchisees, including its own subsidiary Brymon and three based overseas. In 1998, the franchisees flew to 103 destinations, of which 74 were additional to the destinations served by the main BA fleet. Taking into account the services of its subsidiaries and franchisees, BA now serves more destinations from Gatwick than from Heathrow (see Table 5.23).

2.5. Following a period of consistent losses up to the beginning of the 1980s, BA generated a profit in 1983 and has remained profitable since then. In the year to March 1998, it had a turnover of £8.6 billion and profits before tax of £580 million (against £8.4 billion and £515 million respectively in 1996/97). Profit before tax in the first three-quarters of 1998/99 was £310 million on a turnover of £6.9 billion. In 1997, BA embarked on a business efficiency programme aimed at reducing costs over a three-year period by £1 billion annually and it told us that it had so far achieved reductions ahead of target. In the year ended 31 March 1998 BA employed an average of 48,541 people in the UK and a further 12,134 overseas.

CityFlyer Express Limited

2.6. CityFlyer was formed in 1991 by the managers of Air Europe Express, the commuter division of Air Europe which ceased trading when its parent company, International Leisure Group Limited (ILG), went into administration and subsequent liquidation. The airline, which initially carried night freight and mail, was subsequently granted licences to operate passenger services on three routes from Gatwick subject to achieving 'financial fitness'. This required the injection of £1.5 million of funds in addition to the management's contribution of £250,000. These funds were eventually provided by four financial institutions (see paragraph 3.54).

2.7. From the outset, CityFlyer's management took the view that the company could operate profitably provided that it had an appropriate commercial agreement with a major airline for, as a minimum, code sharing (using the major airline's code on tickets and reservation systems) and use of the major carrier's computer reservation systems (CRSs) and worldwide ticketing arrangements. A number of airlines were approached but only BA responded positively. CityFlyer's scheduled services were therefore launched on the basis of a code-sharing arrangement with BA in August 1991. The arrangement proved unpopular with some passengers who were unaware from their reservations that they would be travelling on an airline other than BA. The code-sharing agreement was therefore replaced in 1993 by a full franchise arrangement (see paragraphs 2.37 to 2.40).

2.8. CityFlyer now has 11 turbo prop and five jet aircraft (all leased) with seating capacity ranging from 48 to 110. It provides scheduled services to 12 destinations in the UK and Europe and a thirteenth destination is to be added later this year. CityFlyer also provides charter services on summer and winter weekends, though these services represent less than 3 per cent of its flights.

2.9. CityFlyer has been profitable in every year of its operation except the first. In 1997/98 it made a pre-tax profit of £6.36 million on a turnover of £89.5 million; and, as at December 1998, it had 677 employees including a small number of part-time staff and engineering apprentices at college. Virtually all of CityFlyer's staff are based at Gatwick.

Background on the UK air services industry

Regulatory framework

2.10. Although air services have been the subject of some liberalization in recent years, there remains a substantial degree of regulation (see Chapter 4). Responsibility for regulating civil aviation in the UK rests largely with the Department of the Environment, Transport and the Regions (DETR) and the Civil Aviation Authority (CAA). The DETR makes overall civil aviation policy in consultation with the CAA and within the framework of UK and EC legislation. The CAA's responsibilities include the granting of operating licences and, where required, route licences and in performing these and other tasks it has duties relating, *inter alia*, to competition, the development of the UK's air transport services and the furtherance of the interests of users of those services. Paragraphs 4.35 to 4.40 set out these responsibilities in more detail.

2.11. There are three areas where regulation is of particular relevance to our inquiry—air services to countries outside the European Economic Area (EEA), air services within the EEA and airport congestion.

Air services to countries outside the European Economic Area

2.12. Apart from basic freedoms to fly over other countries or to land in them without putting down or picking up passengers which are provided to all signatories to the International Air Services Transit Agreement, international services to countries outside the EEA remain largely governed by bilateral air services agreements (ASAs). Generally ASAs provide that only airlines effectively controlled by nationals of the signatory countries are allowed to operate services between them. In other respects, ASAs differ from each other, but restrictions on the numbers of airlines and aircraft involved, the capacity and frequency offered, the airports served and the fares charged are commonplace. The provision of air services governed by ASAs generally requires a route licence. In the UK, the granting of these licences is a matter for the CAA which decides where necessary between competing applications to operate on the route and approves fares where they are regulated under the terms of the ASA.

2.13. In terms of the traffic involved, the most important of the UK's bilateral agreements is the Bermuda 2 agreement with the USA. This illustrates the range of restrictions to be found in ASAs (see paragraphs 4.6, 4.14 and 4.15). The number of US cities that can be served from London is limited to 20 and only two airlines from each country can operate to these cities from Heathrow. There is no equivalent restriction applying to services from Gatwick but services from both Gatwick and Heathrow are subject to complex rules regulating the capacity and frequency of flights that can be offered (see Appendix 4.2). Fares are also subject to approval by the authorities of both sides although principles are laid down to limit the scope for arbitrary intervention.

2.14. The DETR, which has principal responsibility for the negotiation of ASAs, told us that it was Government policy to seek agreements that did not restrict the number of airlines or the capacity or frequency offered and that established liberal fare-setting regimes subject to safeguards against excessively high or predatory fares. Some ASAs already provide broadly liberal air services regimes; and charter services to all significant destinations now operate within a generally liberal framework. The DETR noted that negotiations with the USA towards a radical liberalization of Bermuda 2 had continued intermittently since 1993. There had been no substantive progress to date but both sides remained hopeful that a new

agreement could be negotiated in 1999. The DETR considered that the shortage of take-off and landing slots at Heathrow and Gatwick was now a greater barrier to entry to international routes from the UK than any restrictions in the present range of ASAs.

Air services within the European Economic Area

2.15. Air services between airports within the EU, including services within the UK, have been progressively liberalized since 1987 (see paragraphs 4.16 and 4.17). The current framework was introduced in 1993 by the so-called third package of liberalization measures. Any EU airline that meets specified financial fitness, safety and nationality requirements and has an air operator's certificate is to be licensed by the member state within which it has its registered office and principal place of business. It can then operate air services between any pair of airports within the EU subject to rules on safety, the environment and the allocation of slots. It can operate with such aircraft and such frequency as it chooses and it is free to determine its own fares subject to intervention by the relevant authorities to prevent excessive or uneconomic fares. This regime has been extended to non-EC members of the EEA but does not apply to airlines that are majority-owned or controlled by nationals of countries outside the EEA. Such airlines must operate within the terms of the ASA with their home state.

2.16. Other EC regulations provide the European Commission with powers to apply EC competition law (notably Articles 85 and 86) to air transport between Community airports and to regulate specific aspects of these services. In particular, Regulation 95/93 (the EC slot regulation) lays down broad rules for the allocation of take-off and landing slots at 'co-ordinated' EC airports (see paragraphs 4.49 to 4.58). Regulations relating to the other areas of aviation policy and to the competition aspects of various airline agreements are outlined in paragraphs 4.20 to 4.24. Equivalent provisions apply within the EEA as a whole.

Airport congestion

2.17. Airports policy and the systems for allocating limited runway and terminal capacity are an important part of the regulatory framework within which airlines operate.

2.18. At most UK regional airports and at a number of major airports in the USA and elsewhere in the world, airlines are free to schedule and operate their flights more or less at times of their choosing. At more congested airports, specific take-off or landing times, or 'slots', must be allocated in advance of a season to match traffic to runway and terminal capacity. Under the relevant legislation these airports are referred to as fully coordinated airports. There are currently four fully coordinated airports in the UK—Heathrow, Gatwick, Manchester and Stansted, the last of these having become fully coordinated with effect from the summer 1999 season. Apart from some peak hours, Stansted remains a relatively uncongested airport. Congestion at Manchester is also likely to be relieved in the near future by a second runway, currently under construction.

2.19. Congestion is more severe at Heathrow and Gatwick. In both cases, initial overall demand for slots exceeds overall capacity and Heathrow was described to us on more than one occasion as 'full'. Views put to us on the extent of congestion at Gatwick varied but it was generally recognized that the situation there had become significantly more difficult in recent years. For the summer 1999 season initial overall demand for slots on most days of the peak week matched, or exceeded, runway capacity in every hour between 0500 and 1959 GMT (see paragraph 4.64 and Figure 4.2). Demand during the winter season is somewhat lower. The capacity of Gatwick's terminals does not act as a significant constraint.

2.20. The prospects for significant relief of congestion at Heathrow and Gatwick in the immediate future are not good. The inquiry into a proposed fifth terminal for Heathrow has yet to report. The Government announced a study of airport issues in the South-East and East of England on 11 March 1999. This will look at terminal and runway capacity among other things but is not expected to report for two years.

2.21. It was emphasized to us that it had proved possible, year by year, to extract a limited amount of additional capacity from the existing infrastructure at both Heathrow and Gatwick. At Gatwick, overall runway capacity in the most congested hours had increased by 14 per cent since summer 1994 (see Table 4.1). However, Gatwick Airport Limited (GAL), the subsidiary of Gatwick's owner, BAA plc (BAA), responsible for operating the airport, told us that scope for increasing aircraft movements in the most congested hours was now very limited although it was continually seeking ways of achieving marginal increases in runway capacity (see paragraph 4.45).

2.22. The Secretary of State has powers to make traffic distribution rules (TDRs) for airports serving the same area of the UK (see paragraph 4.33). These powers were exercised in 1986 to exclude charter services and new scheduled services from Heathrow in order to relieve congestion there and to build up Gatwick as a second international airport. But the rules were relaxed in 1991 and a number of airlines moved the whole or part of their operations back to Heathrow. The DETR told us that there were no current plans to invoke these powers again in the immediate future.

2.23. Slot allocation at all coordinated UK airports is the responsibility of Airport Coordination Limited (ACL), a company owned jointly by 12 airlines. ACL manages the slot allocation process following rules laid down by the International Air Transport Association (IATA) and by the EC slot regulation. The rules are described in paragraphs 4.48 to 4.59. The key features are that first priority is given to the allocation of slots to airlines which have used them historically and thus acquired rights to them, known commonly as 'grandfather rights'. Second priority is given to requests for slots already held to be exchanged for others to obtain a more favourable departure or arrival time. New entrants (including airlines already operating, but with less than four slots on the relevant day) have first refusal on 50 per cent of the remaining slots.

2.24. Some of those who gave evidence to us expressed reservations about the degree of priority given to new entrants. This was seen as encouraging a rather fragmented use of slots at the expense of development of more competitive schedules by the incumbent airlines. The DETR told us that it had suggested to the European Commission that, as part of its review of the EC slot regulation, it should consider giving higher priority to airlines wishing to provide services to regional airports, perhaps at the expense of the priority that is at present given to new entrant airlines.

2.25. Although the EC slot regulation expressly provides for slots to be freely exchanged, there were differences of view among those who gave evidence to us as to whether it was appropriate or permissible for slots to be exchanged for money. The DETR told us that the Government had yet to take a view on the acceptability of slot trading and that there were differences of view within the European Commission. However, it is clear that the exchange of slots takes a number of different forms, and while our inquiry was in progress a UK court ruled that a transaction involving the exchange of slots constituted an exchange for the purposes of the regulation whether or not accompanied by a monetary consideration (see paragraph 4.57).

2.26. Night-time operations at Heathrow and Gatwick are also subject to Government-imposed noise restrictions. Although runway capacity is not a significant problem at night, the DETR lays down limits on both the number of movements made and the aggregate

amount of noise that can be generated. The administration of these limits is the responsibility of ACL.

Structure of the industry

2.27. Including transit passengers, some 160 million passengers travelled to or from UK airports in 1998. Of those, 77 per cent were carried on scheduled services and 23 per cent on charter services (see Table 5.9).

2.28. In 1997, UK airlines carried some 57 per cent of all passengers using UK airports. BA was by far the largest of the UK airlines reflecting its position as the publicly-owned UK flag carrier until its privatization in 1987. It carried 23 per cent of all passengers and 30 per cent of passengers on scheduled services. The next largest UK operator was the charter airline Britannia Airways Limited (Britannia), carrying some 5 per cent of all passengers, followed by the short-haul carrier British Midland Airways Limited (British Midland) with 4 per cent (see paragraph 5.44 and Table 5.8).

2.29. Virgin Atlantic Airways Limited (Virgin Atlantic) is the only UK carrier other than BA currently operating scheduled services to long-haul destinations. However, British Midland told us that it too intended to introduce long-haul services and had recently applied for licences to operate to a number of destinations in the USA. As to short-haul services, there were 27 UK airlines providing scheduled flights to domestic and European destinations at the end of 1997. No other EC country has as many airlines operating similar services. After BA, British Midland was the largest UK operator of short-haul scheduled services by some margin, carrying 5 per cent of all scheduled passengers, with the largest of the rest each carrying less than 2 per cent of the total. A significant recent development in this sector is the emergence of low-cost no-frills airlines, such as easyJet airline company limited (easyJet) and BA's subsidiary Go based in the UK and Ryanair Limited (Ryanair) and Virgin Express operating services in the UK but based elsewhere. These provide scheduled services to popular short-haul destinations using secondary, less congested airports such as Stansted to benefit from their lower costs.

2.30. The UK also has a substantial charter airline industry carrying around 28 million passengers in 1997 and operating from most significant UK airports.

The London airports

2.31. Some 53 per cent of scheduled flights to and from UK airports and 72 per cent of scheduled passengers leave from or arrive at one of the five London airports—Heathrow, Gatwick, Stansted, London City Airport (City) and Luton Airport (Luton) (see Table 5.9).

2.32. Heathrow remains, by a wide margin, the UK's largest airport. It handles some 30 per cent of all the UK's scheduled flights and 49 per cent of scheduled passengers. Most third parties who gave evidence to us regarded Heathrow as the preferred airport of business travellers. In 1997, some 39 per cent of its scheduled passengers were travelling on business (see Table 5.16); and this accounted for almost 80 per cent of business passengers using London airports. As a result of the TDRs which excluded charter airlines from Heathrow until 1991 and the shortage of slots since that time, Heathrow handles very few charter flights (see Table 5.9).

2.33. In total, Gatwick, with a single runway, has just over half the number of flights handled by Heathrow and 48 per cent of its passengers. Just under one-quarter of its flights are charter services. It is less than one-third of the size of Heathrow in terms of the number

of scheduled services operated and has just over 20 per cent of the volume of Heathrow's business traffic.

2.34. The UK Government's civil aviation policy in the 1970s aimed to develop a 'second-force' airline with Gatwick becoming a second major international airport. As part of this policy, the major Gatwick operator at the time, BCal, was prohibited from using Heathrow. But BCal ran into cash flow difficulties and was acquired by BA in 1987. Thereafter, Air Europe and then Dan-Air attempted to develop sizeable operations at Gatwick but both failed. Air Europe's parent went into liquidation in 1991 and BA acquired Dan-Air for £1 and the assumption of £40 million of debt in 1992. Moreover, when the TDRs were relaxed in 1991 a number of airlines moved the whole or part of their operations back to Heathrow leaving Gatwick underused.

2.35. Gatwick's fortunes since the beginning of the 1990s have been substantially affected by a decision by BA to develop a second hub there. The number of BA's flights from Gatwick rose by 181 per cent between summer 1990 and summer 1998 by which time BA and its subsidiaries and franchisees operated to 74 short-haul and 34 long-haul destinations. Scheduled passenger traffic at Gatwick increased by 47 per cent between 1990 and 1998 against an increase of 41 per cent at Heathrow (see Table 5.10); and business passengers accounted for 29 per cent of Gatwick's total passenger traffic in 1997 against 27 per cent in 1991.

2.36. The other London airports are considerably smaller than Heathrow or Gatwick and, having no scheduled connections to long-haul destinations, are not hubs in the same sense as the two larger airports. But all three have grown rapidly in recent years (see Table 5.10). Helped by the emergence of the no-frills airlines, Stansted in particular increased its share of scheduled passengers using the London airports from 0.7 per cent in 1990 to 6 per cent in 1998.

BA's franchise agreement with CityFlyer

2.37. CityFlyer was BA's first franchisee. The franchise applies only to services on routes approved by BA and operated according to BA's standards. On these services, CityFlyer's aircraft are painted in BA's style and with the BA logo. Cabin interiors and staff uniforms are also to BA's designs. Standards of safety, maintenance and service are set by BA; and staff are trained to BA standards. We were told that, although CityFlyer is identified as the operator of the franchised services, most passengers would assume that they were on a BA flight.

2.38. Services subject to the franchise are sold worldwide through BA's marketing and distribution network; they are shown as BA flights on BA's CRSs and ticketing uses BA's format and ticket stock. Customers of CityFlyer have access to BA's lounges and frequent flyer programmes (see paragraph 5.111) but CityFlyer does not participate in BA's loyalty schemes for travel agents and corporate customers (see paragraph 5.110).

2.39. CityFlyer is free to set its own fares but uses BA's revenue management service to determine the optimum distribution of fares between the different ticket types. It is also free to set its own schedules although we were told that there was discussion and cooperation in this area given the value to both companies of having passenger interconnections ('feed') between their respective services. CityFlyer can operate its own services outside the franchise but, apart from its limited charter operation, it has chosen not to do so. We were told that BA had never refused to grant a licence for a new route proposed by CityFlyer although, as noted in paragraphs 6.58 and 6.156, at least one proposal was opposed by BA before being dropped by CityFlyer for its own reasons.

2.40. CityFlyer and BA told us that both sides benefited from the franchise in a number of ways. CityFlyer had access to advice and services from BA, including its marketing and distribution capability, and it benefited from both the feed from BA's flights and the 'halo effect' of using BA's brand. BA benefited from the fact that CityFlyer had lower costs than BA and was able to operate profitably on lower density routes than would be possible for BA. It could therefore offer its customers a wider range of interconnections at Gatwick than would be possible without the franchise. It benefited from the feed from CityFlyer's services and it also received an annual franchise fee. BA told us that without a mutually supportive arrangement of this kind, its network of services at Gatwick would inevitably contract.

The merger situation

2.41. CityFlyer management and staff told us that they had been aware from the outset that the institutional shareholders would at some stage wish to sell their shares in the business to realize their investment. [

Details omitted See note on page iv.

] In the course of discussions on these issues it had become clear that the institutional shareholders were of the view that the time was right for them to exit the business. It was agreed that the shareholding directors would be given an option over an additional share of the equity [

Details omitted. See note on page iv.

]

2.42. A strategy review carried out for the CityFlyer shareholders at the end of 1997 concluded that an exit should be sought for all investors immediately, that neither the management nor the shareholders had a strong desire to float the company, that the most likely exit route was through a trade sale and that the maximization of value was the highest priority. BA was believed to be the natural acquirer but it was recognized that it could face regulatory problems. It was recommended that competition for CityFlyer among prospective purchasers should be used to maximize the price paid.

2.43. We were told that, while all the shareholders recognized that they had to be prepared to make the sale to a third party if the price was to be maximized, it was also recognized that there were risks in severing links from BA. CityFlyer management considered that if the franchise arrangement were to be terminated, the cost of replacing services provided by BA coupled with the reduction in revenue arising from the loss of the BA brand and code were such that the company would not be viable in its present form.

2.44. BA told us that its preference was for CityFlyer to continue as an independent franchisee. It had concluded, however, that the status quo was not a realistic option and that acquisition represented the only means of ensuring that CityFlyer's services and their valuable feed to BA's network could be maintained. BA therefore made an offer of £75 million. We were told that, at that stage, Virgin Atlantic, [*Details omitted. See note on page iv.*] had expressed interest [✂]. For a number of reasons (see paragraph 3.77), [

Details omitted. See note on page iv.

], the shareholders decided that they should proceed with the sale to BA. An agreement for the sale of CityFlyer to BA, subject *inter alia* to clearance from the competition authorities on terms satisfactory to BA, was signed on 25 November 1998.

Jurisdiction

2.45. Our terms of reference require us to report on whether arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a merger situation qualifying for investigation, as defined in the FTA, in that:

- (a) enterprises carried on by or under the control of BA will cease to be distinct from enterprises carried on by or under the control of CityFlyer; and
- (b) either the value of the assets which will be taken over exceeds £70 million (the assets test) or the merger will create or enhance a share of at least one-quarter in the supply of goods or services of any description in the UK or a substantial part of the UK (the share of supply test).

If so, we have to report on whether the creation of that situation may be expected to operate against the public interest.

2.46. As described in paragraph 2.44, BA entered into an agreement on 25 November 1998 to acquire CityFlyer. BA told us that it wished to proceed with the acquisition in accordance with the terms of the agreement, if it was given clearance to do so on terms that it found satisfactory. This would result in BA acquiring a controlling interest in CityFlyer, so that enterprises of each would cease to be distinct for the purposes of the FTA.

2.47. In making the reference to us, it appeared to the Secretary of State that the share of supply test was satisfied with respect to scheduled air services to and from south-east England. South-east England was defined for this purpose as the area comprised by Greater London and the counties of Kent, East Sussex, West Sussex, Surrey, Berkshire, Buckinghamshire, Bedfordshire, Hertfordshire and Essex.

2.48. The share of supply of air services can be measured in a number of ways but both BA and CityFlyer, in their submissions to us, measured their own shares by reference to numbers of passengers carried. We consider this more practicable than measuring shares of revenue and more meaningful than shares of aircraft movements which, because of differences in the size and loading of each aircraft, give little indication of the scale of business transacted. On the basis of numbers of passengers carried in 1998, BA's share of supply of scheduled services to and from south-east England would increase as a result of the merger from 40 to 41 per cent (see Table 5.11).

2.49. CityFlyer submitted that this figure overstated the true share that would be held by BA as a result of the merger because it took account of passengers who were transferring from one flight to another at airports in south-east England and who were therefore travelling through south-east England rather than to and from it. We do not agree with this analysis. Our terms of reference specify scheduled air services to and from south-east England and our analysis relates to all passengers carried on such services. However, we note that, on CityFlyer's own estimate, BA's share of these services would increase to 33 per cent as a result of the merger, taking account only of passengers starting or finishing their journey at airports in south-east England. We are therefore satisfied that the share of supply test is met in relation to scheduled air services to and from south-east England and, as that is the case, we do not need to consider the share of supply in relation to another area of the UK, or to apply the assets test.

2.50. We are therefore satisfied that arrangements are in progress or contemplation which, if carried into effect, will result in the creation of a merger situation qualifying for investigation.

2.51. Accordingly, we have to consider whether the creation of that situation may be expected to operate against the public interest. We first describe the markets affected by the merger before analysing what its effects would be.

Markets affected

2.52. BA provides scheduled services to seven of the twelve destinations served by CityFlyer (see paragraph 5.151) but in each case its flights are from Heathrow. It has also been put to us by a number of third parties that the merger could affect competition in relation to the services that BA provides to other destinations from Gatwick and Heathrow. We therefore need to consider the markets affected by reference to both CityFlyer's routes and the wider range of destinations served by BA.

2.53. In their own analysis (see paragraphs 6.14 to 6.30 and 6.120 to 6.137), BA and CityFlyer drew a distinction between point-to-point and connecting passengers. In the context of our inquiry, point-to-point refers to travel on one flight between London and another airport with no interconnections with other flights being involved in that journey. Connecting passengers on the other hand are transferring between flights at least once in the course of their journey. In relation to these passengers, our inquiry focuses on the various options open to those using a London airport to make their interconnection. As we note in paragraph 5.7, the term 'connecting passenger' also includes passengers who may start or finish their journey in London but make a connection at the other end of their journey. The characteristics of demand from these passengers are likely to be different from those of passengers making their connection in London but they are a small minority of all passengers and we accordingly do not distinguish them from the generality of connecting passengers in our analysis.

2.54. For point-to-point travellers, CityFlyer and BA submitted that there was a series of route-specific markets broadly comprising services to and from airports in south-east England to and from specific destinations. They acknowledged that the primary catchment areas of airports in the South-East varied and that some passengers, particularly time-sensitive business passengers, would not always regard services from different airports as adequate substitutes. But they believed that the overlap between Gatwick's catchment areas and those of Heathrow and Stansted had increased and that it was reasonable to treat services from Gatwick as competing with point-to-point services from other London airports. Similarly they considered that services to different, but closely proximate, destinations such as Cologne and Düsseldorf would also be regarded as substitutes by many passengers. For connecting passengers, which were currently significant only in relation to services to and from Heathrow and Gatwick, they submitted that there was competition not only from other services on the routes to and from Gatwick and Heathrow but also from services provided between the same points of origin and destination but via alternative airport hubs. Thus services from, for example, Newcastle to Gatwick and Gatwick to the USA were also in competition with services from Newcastle to Amsterdam and Amsterdam to the USA.

2.55. BA and CityFlyer also emphasized that high-speed rail services within the UK and through the Channel Tunnel provided competition to air services on certain routes and that, for some passengers using the London airports, travel to airports outside south-east England was a realistic option.

2.56. The views of other parties varied (see paragraphs 7.70, 7.71, 8.37 and 8.54) but there were some doubts as to how far services from Stansted and Luton could be regarded as substitutes for those from Heathrow and Gatwick and more generally as to the extent to

which services from Heathrow were influenced by competition from other airports. Virgin Atlantic told us that it regarded Heathrow and Gatwick as separate markets, distinct from each other and from the other London airports. It referred in particular to the findings of a 1993 report by the CAA to the effect that, historically, lower fares at other airports had not been matched by those at Heathrow whereas price changes at Heathrow clearly affected fares elsewhere. It regarded Gatwick and Heathrow as distinct from other London airports for a variety of reasons including differences in catchment areas, volumes of traffic, levels of congestion, availability of interconnecting services and operating costs.

2.57. Any one scheduled air service is likely to be carrying passengers travelling for different reasons, from different starting points, to different final destinations and with different demands in terms of flexibility of travelling time and in-flight service. There could therefore be many different views as to what would be an adequate substitute for the flight being used. This in turn would lead to the conclusion that each flight operates in numerous different markets each with a slightly different scope. The definition of air services markets is therefore a difficult and uncertain process.

2.58. The evidence submitted to us suggests that as far as the demand for air services is concerned the range of substitutable options for any one service is likely to differ, in particular, as between:

- (a) passengers travelling point-to-point for leisure purposes;
- (b) passengers travelling point-to-point for business purposes; and
- (c) connecting passengers.

2.59. We first examine these in turn to establish the extent of substitutability of demand as between different services. We then consider whether there might be opportunities for the substitution of supply, either within or between airports, which would lead us to define the relevant markets more widely or narrowly. For the purposes of this analysis, we focus particularly on services to and from the five London airports as Gatwick is the only UK airport from which CityFlyer operates and almost all of BA's services operate to or from one or other London airport. There are a number of much smaller airports in south-east England but they handled only 3,000 scheduled passengers between them in 1998 (see Table 5.12) and operations on that scale are likely to have a minimal impact on demand for BA's and CityFlyer's services. On the other hand we take into account, where appropriate, services from airports outside south-east England including those from airports outside the UK in so far as they may be regarded as substitutes by connecting passengers using the London airports.

Point-to-point leisure travellers

2.60. The proportion of passengers travelling point-to-point for leisure reasons varies widely from route to route. However, as we show in Table 5.2, approximately 42 per cent of all passengers handled by the five London airports in 1996 fell into this category. In general, such travellers are likely to be less time sensitive and more flexible as to their airport of departure than business travellers. Travel to remoter airports has long been a feature of holiday travel on charter services; and the extent to which scheduled services at Gatwick take their leisure passengers from the primary catchment areas of Heathrow (see Table 5.15) lends support to the view that services to a given destination from different airports within reasonable travelling distance are likely to be regarded as substitutes by a proportion of these passengers.

2.61. We note that there is a view (see paragraph 2.56) that Heathrow and Gatwick are distinct from each other and from other London airports. This may have been the position in the past. Indeed, in their 1996 report on Heathrow, Gatwick and Stansted, the MMC observed that the scope for effective competition between airports for originating traffic tends to be limited to that between nearby airports such as Stansted and Luton.¹ However, in relation to leisure travellers at least, we do not now consider that services from the different airports can be seen as operating in different markets. The absence of interconnecting long-haul flights at City, Stansted and Luton airports is not particularly important in the context of point-to-point traffic. Nor do we regard the lower operating costs available to operators at these airports as, in any way, segmenting the market. We note, too, that the CAA now takes a different view on competition between Heathrow and other airports to that expressed in its 1993 statement referred to in paragraph 2.56, to the extent that it has observed responses in the lowest level fares of carriers at Heathrow to the introduction of no-frills services at Stansted or Luton. Other airlines also concurred that there was a degree of competition between the different airports.

2.62. For services from one airport to be influenced by competition from another, it is only necessary, in our view, that a substantial minority of passengers should regard the different services as substitutable. On that basis we are satisfied that as far as point-to-point leisure travellers are concerned, services to a single destination from any or all of the London airports are operating in the same market.

2.63. CityFlyer put it to us that, in some cases, flights to different leisure destinations were operating in the same market because the choice of holiday destination would be determined in part by the air fare. We acknowledge that overall cost is a factor in the choice of destination for many leisure travellers. However, the range of factors other than air fares that would be taken into account is such that competition between air services to quite different destinations can only be very limited and such services cannot, in our view, be regarded as operating in the same market.

Point-to-point business travellers

2.64. There was a consensus among those who gave evidence to us that business passengers were likely to be more time sensitive and less price sensitive than leisure travellers and, as such, less flexible in their choice of airport of departure or arrival. CityFlyer considered that services from Gatwick for both leisure and business passengers were in competition with, at least, services from other London airports including City, Stansted and Luton. It noted, in this context, that services from City had focused on the schedules and destinations that would appeal to business customers, that Stansted and Luton were promoting themselves heavily in the City of London and that the no-frills airlines operating at those airports were attracting a significant volume of business traffic. BA referred us to a number of reports in support of this view (see paragraph 5.16). It believed that the rapid growth of Stansted, Luton and City, the extent to which the no-frills airlines operating there were attracting business passengers and the competitive response of European airlines to services from Stansted and Luton to their hubs illustrated that the no-frills carriers operating at these airports had some impact on existing airlines. It also believed that this competition was affecting overall yields although it acknowledged that it was not as yet clear how far this impact applied across the board or was concentrated on segments such as price-sensitive leisure travellers. BA therefore considered that, although the evidence was not entirely

¹*BAA plc: a report on the economic regulation of the London airports companies (Heathrow Airport Ltd, Gatwick Airport Ltd and Stansted Airport Ltd)*, CAA, June 1996.

conclusive at this stage, there was at least a substantial overlap between the markets for business travellers of the no-frills operators and existing carriers.

2.65. Others noted the continuing preference of business travellers for Heathrow and the CAA told us that there was as yet little evidence of fully flexible fares on Heathrow services being influenced by low fares at other airports.

2.66. We are particularly concerned with identifying the markets in which CityFlyer's and BA's services from Gatwick operate. As regards the substitutability of Gatwick and Heathrow services, we note that business travellers may still have an overall preference for Heathrow. For point-to-point business travellers this may be a response to the greater frequency of services available from Heathrow. However, in so far as this is the reason, Heathrow services might be expected to be susceptible to competition in the form of improved frequencies from Gatwick. In so far as the preference merely reflects tradition and perception, we would not regard it as an immutable barrier to competition between the two airports. In any event, there appears to be an asymmetry in the arguments about competition between Heathrow and other airports. It has not been suggested to us that Heathrow services would be regarded as inadequate substitutes by the generality of business travellers using Gatwick and we do not believe that to be the case. Both airports have good rail links to central London and Heathrow has a good road link; and as we show in Table 5.15, Heathrow draws a substantial proportion of its business passengers from Gatwick's main catchment areas and vice versa. We do not suggest that Heathrow services are reasonably substitutable for Gatwick services in all cases for all business passengers. There are clearly certain catchment areas that are specific to one or other airport. But we consider the area of overlap to be such that, in general, services to common destinations from Gatwick and Heathrow operate in the same market.

2.67. City, with some 62 per cent of its passengers travelling on business (see Table 5.1), is clearly well placed to offer alternatives to business travellers starting their journey in central London, which is an important catchment area for Heathrow and Gatwick (see Table 5.14). It offers relatively few services and limited frequencies but, where City and Gatwick do offer parallel services, we have little doubt that they operate in the same market.

2.68. The extent to which business passengers would regard services from Stansted and Luton as substitutes for Gatwick services is less clear. The role in the market of the no-frills operators who, for the most part, are based at these airports is clearly important. We recognize that there has been a substantial growth of traffic at Stansted and Luton and that the no-frills operators have attracted a significant volume of business passengers. But, as BA has acknowledged, this is to some extent new demand. There is, as yet, little hard evidence that the no-frills operators and the airports at which they mainly operate are drawing business passengers away from Gatwick and Heathrow. In 1996, Stansted and Luton carried less than 6 per cent of the total business traffic of the five London airports and just over 6 per cent of point-to-point business travellers. A proportion of this demand is likely to be new or local traffic. However, the situation is clearly not static. The number of scheduled passengers using Stansted and Luton has grown by nearly 70 per cent since 1996. There is now good rail access from central London to Luton and, particularly, Stansted. There is at least a possibility (see paragraph 5.46) that Stansted will in the future operate scheduled long-haul services for which time sensitivity is not such an important consideration; and it is quite possible, in our view, that increasing congestion at Heathrow and Gatwick could lead to significant changes in the status of Stansted or Luton in the perception of the major airlines.

2.69. We therefore take the view that while services from Luton and Stansted are not substitutable for those from Gatwick for the generality of business passengers, there is at least some overlap in the markets and we would expect the extent of this overlap to increase in the future.

Other options for point-to-point travellers

2.70. For some passengers, whether travelling for leisure or business purposes, services from airports further afield, such as the Midlands airports or Southampton, would provide realistic alternative options. But competition from these airports is likely to operate at the margin and it does not change our judgment as to the core markets.

2.71. High-speed rail services are a potentially more significant factor since they are readily accessible to passengers in the important catchment area of central London (and also Kent in the case of cross-Channel services). CityFlyer told us that its decision to withdraw its Antwerp service was influenced by competition from cross-Channel rail services. Of CityFlyer's current routes, only its London–Newcastle service is in our view susceptible to serious competition from rail services but a wider range of BA's domestic and European routes is likely to be affected.

2.72. We also note that, for some point-to-point travellers from the UK, there will be a choice of airports convenient to their final destination. Among the routes served by CityFlyer, services to Cologne and Düsseldorf are substitutable to a degree because those two airports are less than 40 miles apart.

Connecting passengers

2.73. As can be seen from Table 5.16, some 34 per cent of scheduled passengers using Heathrow in 1997, and 35 per cent of those using Gatwick, were connecting passengers. These passengers generally need to fly to or from the airport used by their connecting flight. CityFlyer told us that some leisure passengers are prepared to transit between airports for the purposes of interconnection but we find it difficult to believe that a significant proportion of passengers would be prepared to do this where they had the choice of a more direct inter-connection.

2.74. However, we also need to take account of the fact that passengers can have a choice of airports at which to make their connection. We were told, in this context, that airlines are making increasing efforts to attract connecting passengers to their hubs and BA submitted that, as far as services from Gatwick and Heathrow were concerned, this form of hub competition was intense.

2.75. While we accept in principle that hub competition exists, it is likely to bear unevenly on different services according to the interconnecting options available to passengers using them. We have therefore considered how far passengers connecting at Gatwick are able to reach their destination via alternative hubs. We first note that KLM and Sabena, in particular, have significant networks of services connecting UK airports outside London with their hubs in, respectively, Amsterdam and Brussels. We further note that according to data provided by the CAA, of the 125 destinations served from Gatwick, 72 are also served from Heathrow, 79 from Amsterdam, 80 from Frankfurt and 79 from Paris. The same data suggested that UK passengers starting their journeys in Manchester have connections to all four of these alternative hubs, those starting in Belfast, Edinburgh, Leeds/Bradford and Newcastle have connections to three of them, passengers from Aberdeen, Glasgow, Guernsey and Jersey can connect to two of them and of passengers from the airports surveyed, only those from Plymouth and Newquay have no choice but to connect at Gatwick. Similarly, passengers starting their journeys at the destinations served by CityFlyer have a range of options for reaching long-haul destinations (see paragraphs 5.221 to 5.229).

2.76. This represents only a partial snapshot of the options available to connecting passengers. A full survey may have revealed more circumstances in which connecting

passengers using Gatwick have no alternative. However, the evidence already available indicates that services across alternative hubs are likely to be an influential factor of competition on a sufficiently wide range of services to and from Gatwick to be of considerably more than marginal significance.

2.77. The effect of hub competition on short-haul services is possibly more limited than on long-haul services. BA told us that ‘the real competition’ on interconnecting flights is between long-haul operators. This seems likely in the case of long-haul journeys given that fares, comfort and service standards on the long-haul sector are more likely to determine the passenger’s choice of airline than the conditions of travel on the short feeder leg. However, at the margin, a feeder service to a different hub at a better time of day or at lower cost could tip the choice between different routes. Moreover, not all interconnecting services involve long-haul sectors. Passengers travelling from UK airports outside London who do not have direct flights could have the choice of travelling to short-haul European destinations via London, Paris, Brussels or Amsterdam. In those circumstances, a service from Heathrow or Gatwick could be competing with either the service from the UK to the European hub or the service from the European hub to the final destination.

2.78. We therefore take the view that, as far as connecting passengers are concerned, services from Gatwick are operating in a market comprising services to or from the passenger’s starting point or destination together with services on other routes between those two points via alternative hubs.

Substitutability of supply

2.79. We have so far looked at demand. Before deciding on the overall scope of the markets affected by the merger we must consider whether there are currently possibilities for airlines to switch their resources from one service to another—‘supply side substitution’—and whether this requires us to adopt a different definition of the market. In particular we must consider whether, as has been suggested to us, Gatwick comprises a separate market.

2.80. It is clearly possible for airlines to use their assets in different ways. An aircraft, crew, check-in desk and loading and unloading facility could serve a flight from Gatwick to Paris as adequately as a flight to Brussels. To the extent that such a switch can be made easily and quickly, supply-side substitutability exists and the switchable services fall within the same supply-side market. To the extent that the services cannot be switched at all or, at least, not without delay and uncertainty, they do not fall in the same supply-side market.

2.81. At Gatwick the scope for switching services is likely to vary route by route. On routes to EEA destinations, entry is largely unconstrained by regulation and provided that aircraft and crew requirements are similar the main potential inhibition to switching would be the availability of appropriate slots. This points to the existence of a supply-side market at Gatwick comprising a range of services to EEA destinations and in which the availability of slots is an important competitive factor. On other routes entry is more restricted. The need to observe the conditions of ASAs or to wait for the terms to be renegotiated could be a significant barrier to switching. There could also be technical inhibitions. Different aircraft may be needed and this may give rise to a requirement for different crew, different loading facilities and potentially more check-in facilities as well as for different slots. We do not therefore believe that the supply-side market at Gatwick extends to all services.

2.82. There is also a possibility for services to be switched between different London airports. This is particularly true for airlines such as BA and Virgin Atlantic that have existing operations and facilities at both Heathrow and Gatwick. It may be less true for a major

operator with maintenance and passenger-handling facilities at only one airport although the existence of local providers of check-in and handling facilities makes small-scale switching easier. Differences in operating costs may also represent a barrier to switching between airports such as Stansted and Luton and the relatively high-cost airports such as Heathrow and Gatwick and switching in the opposite direction could be inhibited by the absence of transfer traffic from Stansted and Luton.

2.83. It is therefore not possible to generalize about the scope of the supply-side markets. But we take the view that they correspond very broadly to the markets that we have already identified except that, in the case of a route to an EEA destination, there is a degree of substitutability with routes to other EEA destinations and the market therefore arguably extends to those destinations.

Conclusions on the markets affected

2.84. In summary, the markets affected by the merger can be defined as follows:

- (a) For point-to-point leisure travellers, the core market comprises services from the five London airports to common destinations or, in some circumstances, to nearby airports. As this often involves routes between London and another city we refer to this market as a city-pair market.
- (b) The core market is broadly similar for point-to-point business travellers. However, in this case, we consider that competition from Stansted and Luton operates at the margin of the market.
- (c) On certain routes, CityFlyer and BA also operate in the same market as high-speed rail services, at least in so far as point-to-point travellers are concerned.
- (d) In relation to connecting passengers, the market affected comprises two components. The first is routes to and from the airport where the passenger makes the connection. Because these passengers must generally fly to the particular airport at which the connection is to be made, we call this an airport pair market. The second component comprises other routes between the connecting passenger's starting point and destination via alternative hubs.
- (e) We also need to take account of a wider supply-side market comprising substitutable services between London and different EEA destinations.

Public interest issues

2.85. In the course of our inquiry we received a range of opinions about the possible effects of the merger from third parties including other airlines, representatives of air transport users, regulatory bodies, representatives of places and airports served by CityFlyer, staff representatives and members of the public (see Chapters 7 and 8). A number of airlines, but not all, were opposed to the merger as were members of the public who wrote to us. The Air Transport Users Council (AUC) and the Consumers' Association considered that there were arguments for and against the merger but felt that, on balance, it would operate against the public interest. Of the airports, authorities and individuals representing the interests of the places currently served by CityFlyer, some were against the merger and some were in favour. The trade unions and CityFlyer's staff were also in favour of the merger. Before addressing the public interest issues we first summarize briefly the concerns expressed to us.

2.86. For most of those who commented, the potential loss of competition between BA and CityFlyer was not seen as a major issue. There was, however, a widely-held concern that BA would withdraw CityFlyer's current services or stand in the way of the introduction of new ones in order to use the slots on more profitable routes. It was put to us, in particular, that increasing the frequency of services on routes where there was already substantial capacity was less beneficial to air transport users than the maintenance of route diversity.

2.87. Airlines which opposed the merger were principally concerned about the share of slots at Gatwick that would be controlled by BA. It was felt that this would adversely affect competition in two ways in particular. First, BA's existing competitive advantage would be strengthened by its greater ability to shuffle its large portfolio of slots and services. It would be easier for BA both to make use of slots becoming available through the normal slot allocation process and to restructure its services rapidly to respond to new opportunities or to new competitive pressures. It was felt that the existing scale of BA's holding of slots gave it an advantage over competitors in these areas and that this would be strengthened further by the merger. Secondly, there was concern that the merger would foreclose any possibility of actual or potential competitors of BA obtaining some or all of CityFlyer's slots in the future.

2.88. There were similar concerns about the possibility of BA acquiring greater influence over the allocation of airport facilities at Gatwick and some airlines had more specific fears that the merger would lead to greater congestion in the North Terminal to the detriment of passengers and other airlines. The charter airlines foresaw difficulties arising from BA's acquisition of CityFlyer's entitlement to night movements and noise quota at the airport.

2.89. In considering the public interest, we must focus first on the outcome of the merger currently proposed. As we note in paragraph 2.41, the merger arises because CityFlyer's institutional shareholders wish to sell the business in order to realize the value of their investments in it. We must therefore consider what may be expected to occur if the merger were not to proceed and take this into account in our assessment of the effects of the merger on the public interest.

2.90. Accordingly our analysis has five stages. First, we consider a range of concerns about the situation that would arise in relation to competition and consumer choice if the merger were to proceed. Secondly, we consider what may be expected to occur if the merger were not to proceed and its various implications. Next we examine the wider competitive pressures on BA and consider whether, and if so how far, they mitigate any concerns identified. We then turn to the benefits that may be expected to arise from the merger. Finally we balance the merger's overall detriments and benefits.

Concerns arising if the merger were to proceed

2.91. Taking into account the views that have been put to us, we have identified six main areas of concern. First is the extent of competition and choice on the routes served by CityFlyer if the merger were to go ahead. Second is the possible loss of the route diversity provided by CityFlyer. Third is the potential for BA to use the additional slots it would acquire to the disadvantage of competitors. Fourth is the effect on the ability of other airlines to obtain slots at Gatwick. Fifth is the potential for a reduction in the availability to other airlines of entitlement to night movements and noise quota at Gatwick. And finally is the possibility that the merger would give BA greater influence over the allocation of airport facilities to the disadvantage of other airlines. We now consider each of these issues in turn.

Competition on routes served by CityFlyer

2.92. BA provides services to seven of the twelve destinations currently served by CityFlyer's scheduled services ('the overlap routes') but CityFlyer's services on these routes are all from Gatwick and BA's are from Heathrow. The destinations involved are Amsterdam (AMS), Cologne (CGN), Düsseldorf (DUS), Luxembourg (LUX), Zürich (ZRH), Jersey (JER) and Newcastle (NCL). Table 2.1 shows the shares of passengers on each of these routes held by CityFlyer, BA and other airlines indicating the London airport from which the services are operated.

TABLE 2.1 **Share of passenger numbers on the overlap routes, 1998**

Route	<i>per cent</i>						
	NCL	AMS	CGN	DUS	JER	LUX	ZRH
BA (LHR)	68	20	44	51	37	22	31
CFE (LGW)	25	5	25	10	19	27	9
BA+CFE	93	25	69	61	56	49	40
Other LHR	-	44	30	29	-	35	49
Other LGW	-	8	-	-	30	-	2*
STN	-	11	-	10	12	15	-
LCY	7	5	-	-	-	-	8
LTN	-	6	-	-	3	1	2

Source: Table 5.27.

*BA's service at Gatwick since discontinued.

Note: Columns do not sum to 100 because of rounding.

2.93. CityFlyer and BA submitted that these figures overstated their market shares because they included connecting passengers and excluded services via other hubs that competed for these passengers (see paragraphs 2.73 to 2.78). They argued that the competitive impact of the joint BA and CityFlyer shares of passengers on individual routes should be assessed on the basis of point-to-point passengers alone. On the basis of estimates by CityFlyer and BA (see paragraphs 5.136 and 5.137), the share of CityFlyer's passengers that are connecting passengers is somewhere in the range 18 to 27 per cent. A 1997 CAA survey, which, unlike CityFlyer's estimate, takes into account passengers connecting without a through ticket, indicates that the proportion of passengers travelling on the overlap routes that are connecting passengers varies route by route in the range 20 to 54 per cent (see Table 5.28).

2.94. While recognizing that a substantial number of travellers on the overlap routes are connecting passengers, we do not agree that such passengers should be eliminated from the calculation of market shares on these routes. In assessing the impact of the merger, we have to look at its effect on all passengers on these routes. The merger could deprive connecting passengers of potential competition between BA and CityFlyer, on one sector of alternative routes across the Gatwick and Heathrow hubs. However, we accept that, apart from the competition on the overlap routes from carriers other than BA and CityFlyer, passengers inter-connecting at Gatwick or Heathrow have the option in many cases of travelling over another hub. While hub competition may not be of such significance to the short-haul leg of many journeys as it is to the long-haul sector (see paragraph 2.77), we recognize that the availability of this choice will act as a constraint on BA and CityFlyer on the overlap routes in so far as connecting passengers are concerned and we take that into account.

2.95. For connecting passengers requiring a service specifically to or from Gatwick the only change brought about by the merger would be that CityFlyer's services operated under new ownership and, as CityFlyer already operates under BA's brand, using BA's service standards and BA's tickets, most passengers would be unlikely to perceive any change at all.

There would be no effect on the competitive structure of the routes to and from Gatwick since there are currently no overlaps between BA's and CityFlyer's services at Gatwick. Whether there would be a greater impact on competition if the merger were not to proceed is an issue that we take into account in considering the alternatives to the merger (see paragraphs 2.148 to 2.168).

2.96. For point-to-point passengers, there is currently a choice of BA or CityFlyer services to the destinations served by CityFlyer and the merger would clearly increase BA's share of the city-pair markets on the overlap routes. We have looked at the extent of competition on each of the routes in paragraphs 5.162 to 5.171.

2.97. For services to Amsterdam, Zürich and Luxembourg competition from other airlines and other airports is such that we do not believe that the overall level of competition and choice for passengers would be substantially affected. BA's share on the Jersey route would be higher but with a significant direct competitor at Gatwick and smaller competitors providing services at other airports, including a regular service from Southampton, it would continue to be subject to significant competitive constraints, particularly as some 40 per cent of CityFlyer's passengers on this route are in the less time-sensitive leisure category.

2.98. BA's shares on the Düsseldorf and Cologne routes would be significant by any standards. We note that as regards the Düsseldorf route, there are services from City and Luton to Düsseldorf Express Airport, some 20 kilometres from Düsseldorf, and that this might provide a degree of additional competition. We note too that Cologne is a relatively thin route (ie a route on which there are relatively few passengers—see Table 5.20) and that CityFlyer intends to reduce its services from the current season. This raises doubts that such a route could sustain three directly competing operations. There is also a degree of competition between services to Cologne and Düsseldorf given the proximity of those two destinations. However, on both routes, over half the point-to-point travellers are business passengers who would be less likely than other passengers to regard services from other London airports to alternative destinations to be adequate substitutes for the overlap routes themselves. We therefore regard the high level of concentration on the Cologne and Düsseldorf routes from Gatwick and Heathrow that would result from the merger as a cause for concern.

2.99. The Newcastle route, where BA would have a 93 per cent share of passengers, is notable for the high proportion (54 per cent) of passengers that are connecting passengers. As can be seen from Appendix 5.8, a significant proportion of long-haul travellers from Newcastle can and do travel to hubs in Continental Europe and this would in our view provide a significant competitive constraint in relation to at least half of BA's passengers on the route. High-speed rail services, which operate every 30 minutes from Newcastle to London, also seem likely to provide an element of competition. With a full economy air fare at £140 and a first class rail ticket at £106, and smaller differences between discounted fares, rail and air fares on this route are no longer so far apart as to suggest a clear separation of the two markets. Some 78 per cent of point-to-point travellers on the overlap routes are business passengers who may be sensitive to the inconvenience of a long rail journey but, as we show in paragraph 5.97, overall journey times by air and rail between Newcastle and London are broadly comparable. Competition from rail is likely to be less effective in the case of passengers with connecting flights at Heathrow or Gatwick but, as noted above, these are likely to see an air service via another hub as the most competitive alternative. Overall we believe there will be some significant competitive constraints on BA on this route and we would not therefore regard the situation arising from the merger as having any appreciable adverse effect on competition.

2.100. More generally, we recognize that all of the overlap routes, except Zürich, are within the EEA so that regulatory barriers to entry are low. Slot constraints may make entry at Gatwick and Heathrow difficult but there is more scope for competitive entry at the other London airports, and as we note in paragraph 2.81, there is some scope for the substitution of supply by airlines switching the use of existing slots to the overlap routes if prices on those routes became excessive.

2.101. BA and CityFlyer submitted that, in assessing the effect of the merger on the overlap routes, we should also take account of the close existing relationship between them that had developed under the franchise (see paragraphs 2.37 to 2.40). On that issue we note that, although the franchise agreement implies a high degree of co-operation between BA and CityFlyer on route selection and service standards, it leaves CityFlyer free to set its own fares. For the most part, CityFlyer has chosen not to exercise that freedom but it has the potential to do so and is unencumbered in its efforts to attract passengers to fly from Gatwick by concerns about the profitability of BA's services from Heathrow. The merger would reduce that potential competition and choice. We are also concerned with what would happen in the absence of the merger, to which subject we return in paragraph 2.148.

2.102. In relation to point-to-point travellers therefore we believe that the situation arising from the merger would be one of diminished actual and potential competition on the overlap routes but that, in the case of routes to Amsterdam, Zürich, Luxembourg, Jersey and Newcastle, the degree of diminution would be insignificant. It would be more significant in the case of Cologne and Düsseldorf and, although there are a number of mitigating factors, we consider that there would be a net loss of competition of which we should take account in assessing the public interest.

Route diversity

2.103. Certain third parties (see paragraphs 7.78, 7.100 and 8.70) have also put it to us that, if BA were to acquire control of CityFlyer's slots, it would use them to provide further services on its existing more profitable long-haul routes with adverse consequences both for competition on the routes served by CityFlyer and for the consumer interest in route diversity. It was suggested that BA could bring this about in a number of ways. CityFlyer's slots could be switched to long-haul services from Gatwick; or, with CityFlyer's services under its control, BA could decide to withdraw its own short-haul services on an overlap route to release Heathrow slots for more profitable uses. The AUC told us that it regarded an increase in frequency on routes on which there was already adequate capacity as less preferable from the point of view of passengers than the introduction or maintenance of services on a wider range of routes. This could also have implications for regional access to the London airports and we received expressions of particular concern about the future of services to Newcastle and Guernsey (see paragraphs 7.100 and 8.70).

2.104. BA and CityFlyer both told us that, while the management of the CityFlyer operation would retain a high degree of autonomy in matters such as route selection, they would expect CityFlyer's services to evolve with changes in the market. However, they also emphasized that the range of CityFlyer's short-haul services was likely to be developed rather than curtailed if the merger were to proceed. BA put it to us that it had never previously eliminated a service to a short-haul destination to increase its long-haul network from Gatwick and that, if it wished to do that now, it would be more likely to reduce its own short-haul services than to interfere with CityFlyer's lower-cost and generally more profitable operations.

2.105. It is unlikely that any airline would maintain a fixed route structure in perpetuity. CityFlyer itself withdrew services on two routes in 1998 and has introduced services on other routes in their place (see paragraph 3.49). While we accept that BA intends to give the managers of CityFlyer a high degree of autonomy, we would not expect that to stand in the way of the sacrifice of one or more of CityFlyer's routes if the commercial imperative within BA was strong enough. However, we have considered the relative profitability of BA's and CityFlyer's services (see paragraphs 5.189 to 5.192) and it is clear that, taking into account both route profitability and the value of feed to BA's long-haul services, a significant number of BA's short-haul services are less profitable than even the least profitable of CityFlyer's services. We do not rule out the possibility that strategic considerations might lead BA to want to retain certain less profitable routes in preference to more profitable ones. But, in our view, commercial logic generally supports BA's claim that CityFlyer's services are less susceptible to elimination than some of its own. As BA already has considerable scope to switch slots from its less profitable to its more profitable services or to withdraw Heathrow services on short-haul routes also served, either by BA or its franchisees, from Gatwick, we can find no basis for an expectation that the merger would increase the risk of closure of CityFlyer's existing services.

BA's use of its larger slot portfolio

2.106. Some third parties expressed concern to us (see paragraphs 7.59 and 7.76) that BA would gain a significant additional competitive advantage over other airlines from an increase in the number and variety of slots and services under its control. It would be able to respond more quickly than its competitors to new market opportunities and to competitive threats and would be better able to consolidate its position of strength on existing routes. It would also have more options for using the kind of less desirable slots that were commonly available from the pool until such time as they could be retimed or exchanged for better slots.

2.107. Table 2.2 shows the proportion of all available daytime slots at Gatwick held by BA, CityFlyer, BA's subsidiaries and franchisees and other airlines that received an allocation of 2 per cent or more of these slots for the peak week of summer 1999.

TABLE 2.2 **Weekday slot holdings at Gatwick: peak week summer 1998 and allocation for summer 1999**

Airline	Slots held		Share of total available slots %	
	Summer 1998*	Summer 1999†	Summer 1998*	Summer 1999†
BA	1,434	1,395	26	25.0
BA's subsidiaries	202	220	4	4.0
CityFlyer	<u>638</u>	<u>668</u>	<u>12</u>	<u>12.0</u>
BA + subsidiaries + CityFlyer	2,274	2,283	42	41.0
Other BA franchisees	<u>168</u>	<u>243</u>	<u>3</u>	<u>4.3</u>
BA + subsidiaries + other franchisees	2,442	2,526	45	45.3
Air 2000	158	242	3	4
Caledonian	226	219	4	4
Jersey European	204	199	4	4
Monarch	188	203	3	4
Britannia	136	163	3	3
Flying Colours	-	129	-	2
Alitalia	92	84	2	2
Airtours	91	96	2	2
Virgin Atlantic	61	96	1	2
Airworld	82	-	2	-

Source: Table 5.40.

*Slots used.

†Allocated as at 28 March 1999.

2.108. We have considered whether, in looking at the extent of BA's control of slots, we should take into account those held by both its subsidiaries and its franchisees. We accept that slots held by BA's subsidiaries are effectively controlled by BA. However, we do not believe the same to be true of slots held by BA's franchisees. As we note in relation to CityFlyer's franchise, BA can refuse to license a route under the franchise but cannot compel the franchisee to use a slot for a particular purpose or prevent it from operating a route outside the franchise; nor can it determine the franchisee's fares or control the acquisition or disposal of its slots. There are therefore substantial limitations to BA's ability to control its franchisees' slots. However, the scope for BA and its franchisees to cooperate in the identification, development or restructuring of feeder services is, by itself, an additional element of flexibility that is not available to most of BA's competitors at Gatwick and we take that into account in our assessment.

2.109. As Table 2.2 shows, while, if the merger were to proceed, airlines other than BA and its subsidiaries and franchisees would, collectively, hold over half the slots available at Gatwick, there would be a very large difference between the size of BA's holding and that of any other individual airline. We heard differing views as to how much of an advantage this would give BA in terms of its ability to acquire and use additional slots. Certain airlines suggested that there was a substantial advantage to those who obtained a critical mass of slots and services. CityFlyer, however, cited its own experience as evidence that it was possible for airlines to build up slots gradually.

2.110. It is arguable that if there is a critical mass beyond which the acquisition of new slots becomes easier, BA has already achieved it and the incremental effect of the merger would be limited. However, against this, there is a view that it becomes progressively easier to use slots as the range of routes and services on which to use them becomes greater. On that basis, BA clearly has an advantage over its competitors and the acquisition of CityFlyer, which would increase the size of BA's slot portfolio at Gatwick by some 40 per cent, would at the very least consolidate that advantage.

2.111. As to the greater flexibility conferred on BA by a larger slot portfolio, we would first note that, for the reasons given in paragraph 2.105, we do not expect BA to find it necessary or desirable to discontinue CityFlyer's services, rather than its own, in order to gain advantage on other routes. Moreover, as noted in paragraph 2.40, BA gains some competitive advantage from its existing relationship with CityFlyer and, to that extent, the incremental effect of the merger is likely to be limited. However, the acquisition of full control over CityFlyer's slots clearly gives BA a wider range of options to adjust schedules, to increase or reduce frequencies or to restructure its network, and this does in our view give BA an increased advantage over its competitors.

2.112. The strengthening of BA's competitive advantage in these ways is a cause for concern but it is necessary to consider more broadly the extent to which BA is subject to competitive constraints in the markets in which it operates. We return to this question in paragraph 2.169.

Foreclosure of competition for BA

2.113. A number of airlines (see, for example, paragraphs 7.61 and 7.66) told us that their major concern was that the merger would effectively preclude for all time the possibility that CityFlyer's slots would become available to actual or potential competitors of BA whether through the slot exchange mechanism, slot trading or the acquisition of CityFlyer. To address this concern we need to consider how the situation at Gatwick would be affected by the merger and, more specifically, what scope it would leave to BA's competitors to establish or expand their operations there. But we must then consider the situation with regard to slots at Gatwick in the context of the general competitive situation in the markets in which BA operates. We consider the first of these issues now, summarizing briefly the concerns expressed to us before examining the situation at Gatwick. We return to the second issue in the context of our wider analysis of the competitive pressures on BA in paragraph 2.169.

Views

2.114. Virgin Atlantic put it to us that the merger would foreclose competition and, more specifically, that it would 'remove the last significant opportunity for any [of BA's] competitors to penetrate the market for scheduled air services in the south-east of England'. It told us that, if the merger were to proceed, BA and its subsidiaries would directly control 60.4 per cent of all scheduled service slots at Gatwick in addition to their share of 37 per cent of slots for scheduled services at Heathrow. In its view a presence at Heathrow and Gatwick was essential for scheduled services and neither Luton nor Stansted offered realistic opportunities for rival carriers to compete with BA. But there were now virtually no slots available on a commercially realistic basis which would enable viable entry into either Gatwick or Heathrow. Slots were not available in sufficient quantities through the system of transfers. BA had built up its own holding of slots by acquisitions but, apart from the portfolios held by BA and CityFlyer, slot holdings were now so thinly spread among other airlines that it would not be possible for a carrier such as Virgin Atlantic to build up slots by acquiring other airlines. If the merger were prohibited, CityFlyer would continue to control the use of its slots and there would remain the possibility of CityFlyer being taken over by another non-dominant carrier or exchanging slots with other airlines. Unlike BCal and Dan-Air when they were acquired by BA, CityFlyer was profitable and BA was not the only prospective purchaser.

2.115. Similar concerns were expressed by other airlines. Ryanair was particularly concerned about BA's control of peak-hour slots and about the possibility that airlines using independent feeder services would find it increasingly difficult to operate at Gatwick. easyJet, which operates largely from Luton and Stansted, submitted that there was a market for low-cost air services south of the Thames which it was impossible for the no-frills airlines to fulfil because of BA's control of slots.

2.116. BA and CityFlyer maintained that the merger would not change the present position as CityFlyer's slots would continue to be used for the same kind of operation. In any event, they believed that it was still possible for other airlines to acquire slots at Gatwick. New slots, not covered by grandfather rights, became available to airlines each year. There was also at least some scope for further expansion of runway capacity. CityFlyer had built up its slots by acquiring slots that were not ideal and taking the first opportunity to upgrade them through the normal slot allocation process. Other airlines could do the same and there were several examples of airlines improving their slot holdings recently. Slots were also available through exchanges and opportunities for the acquisition of airlines arose from time to time. Moreover there was room for airlines to expand at Stansted.

2.117. BA submitted that perhaps the most important consideration was that, even if it controlled CityFlyer's slots, it would still be subject to effective competition across its network as a whole. BA faced competition from other airlines on the majority of city-pair routes on which it operated. On the denser routes, for example across the North Atlantic, there were many competitors. Competition for BA from domestically-based airlines was already much stronger than was the case for other European airlines. It also faced competition from competing networks carrying passengers across their hubs as an alternative to the use of London. The airports at which BA's main European competitors had their hub operations were larger than either Gatwick or Heathrow and those competitors had a larger share of slots at their respective hubs than BA had at Gatwick or Heathrow. The strength of competition was evident from the pressure on BA's profits and yields and its commitment to a major business efficiency programme.

Availability of slots at Gatwick

2.118. We consider the points raised by BA about wider competition in paragraphs 2.169 to 2.177. We turn first to the argument that the merger would not foreclose competition because it would lead to no fundamental change to the way that CityFlyer's slots are used at present.

2.119. Against the background outlined in paragraph 2.41, it is not clear that the status quo would be preserved if the merger were not to proceed and we consider what might be expected to happen in that event in paragraphs 2.148 to 2.168. However, we believe that the loss of CityFlyer's independence from BA would, by itself, raise potential competition issues that need to be addressed. As long as CityFlyer remained independent of BA there would be the potential for the company's slots to be used in competition with BA, either by CityFlyer as it stands or under new ownership or by other airlines acquiring the slots if, for some reason, CityFlyer were to decide to exchange them or return them to the pool. The pressure on slots at Gatwick and Heathrow and BA's record of a steady build-up of its slot portfolio at Gatwick persuade us that BA could not be expected to give up CityFlyer's slots once it had acquired them. The potential for CityFlyer's slots to be used in competition with BA would therefore be lost if the merger were to proceed. The loss of that potential would, by itself, change the conditions in which BA operates at Gatwick and we need to consider whether these changes are of any significance.

2.120. If the merger were to proceed, BA and its subsidiaries would control 41 per cent of all daytime slots available at Gatwick for the peak week of the summer 1999 season and 58 per cent of all slots allocated for scheduled services (see Table 5.40). Their largest holdings would be in the morning and evening peak hours beginning at 0700 and 1700 GMT in which their shares of all available slots would be 65 per cent and 67 per cent respectively (see Appendix 5.9, Table 1).

2.121. It was put to us that, in considering the implications of these shares, we should focus particularly on scheduled slots because other slots were unusable for scheduled services. It is clearly true that some of the slots used by charter airlines are at times of day less favoured by scheduled operators. But this is not invariably the case. As Figure 5.1 and Table 5.41 illustrate, a significant number of the slots held by charter operators were at times of day when scheduled service operators were also active and, as CityFlyer and others have demonstrated, even slots at times less favoured by scheduled service operators can be upgraded over time. We do not therefore consider that the proportion of slots currently used for scheduled services by BA's competitors is a good guide to the level of potential competition and access at Gatwick.

2.122. As BA has pointed out, it is not unusual for airlines operating networks to have a large share of slots at their hubs. BA's shares at Gatwick and Heathrow are lower, not only than those of its largest European competitors, but also of most other hub operators at European and US airports (see Table 5.38). But BA does operate hubs at both Heathrow and Gatwick. Taken together, they handle slightly more flights than those of some of BA's European competitors, although still somewhat less than those of most major US airlines. However, it is unusual for passengers to be prepared to switch between airports to make a connection and this has forced BA to produce a degree of duplication in its short-haul network to provide feeder services to both Heathrow and Gatwick. It is not therefore realistic to compare the aggregate of BA's slots at Heathrow and Gatwick with those held by its competitors at a single hub.

2.123. BA submitted that its slot holding at peak hours was also not unusual for a hub operator and it drew our attention to a decision by the European Commission in which a joint operation between Air France and Sabena at Brussels airport was permitted to hold up to 75 per cent of slots in any one hour and up to 65 per cent in any two hours.¹ We do not regard the circumstances of that case as necessarily applicable to the situation that we are investigating and we note that the decision was made subject to other safeguards to preserve competition. But we accept in principle that an effective hub operation servicing a diverse network of short-haul routes requires a substantial holding of slots at the peak hours, and in particular at the morning and evening peaks for the arrival and departure of short-haul traffic.

2.124. However, if the merger were to proceed, BA's competitors would have to share a little over half the capacity of Gatwick between them and between 30 and 40 per cent at peak times. Although that may not be untypical at airports accommodating a hub operation, we need to consider how far it forecloses competition.

2.125. We first note that daytime runway capacity at Gatwick increased by around two and a half per cent between the summer 1998 and summer 1999 seasons and that slots allocated increased by just over 3 per cent² (see Table 5.40). ACL told us that, in the most active period (0500 to 1959 GMT), capacity in the peak week increased by 1.3 per cent while the number of slots that became newly available for allocation totalled 6.6 per cent of all slots allocated for that period. In the less favoured part of the day, between 2000 and

¹Commission Decision 5 October 1992 (Case No IV/M157) OJ C272 21.10.92.

²As at 28 March 1999.

2230, almost half the airport's capacity for the period was available for allocation. Very few slots in the peak hours beginning at 0700 and 1700 respectively became available for allocation, but it is noteworthy that whereas these two peak hours accounted for only 1.6 per cent of the relatively few successful bids for new slots, they were involved in over 11 per cent of the larger number of successful requests for existing slots to be retimed (see Appendix 4.5, Table 1). Moreover the general spread of available slots through the day is such that it is reasonable to expect at least a proportion of them to be commercially viable.

2.126. However, Virgin Atlantic told us that it was now almost impossible to obtain commercially viable slots at Gatwick and provided us with evidence of its own recent experience in applying for slots at both Heathrow and Gatwick. As can be seen from Appendix 5.10, it applied for slots to operate 13 routes from Gatwick in the summer 1999 season and received slots for only half that number. This broadly reflected the position in Heathrow and Gatwick taken together where Virgin Atlantic was allocated only half the slots applied for. This was a lower rate of success for the company's applications than in any summer season since 1993. Nevertheless, Virgin Atlantic has managed to almost double its combined slot holding at Heathrow and Gatwick since summer 1996 and over the same period it has increased the number of routes it operates from Gatwick from four to seven. In Table 5.39 we show how BA and its subsidiaries and franchisees have also built up their slots in recent years.

2.127. While the slots available at Gatwick do not meet all the aspirations of the airlines operating there, the evidence suggests that there is still movement in the system and that the development of new or existing services by airlines other than BA and CityFlyer is by no means entirely foreclosed. The volume of slots becoming available through the normal slot allocation system is unlikely to support a rapid build-up of services. The process of developing a substantial presence at Gatwick is likely to be gradual and to require a degree of patience and possibly the use of suboptimal slots until better alternatives become available. However, as we note in paragraph 4.66, requests for the retiming of slots are second only to historic rights in terms of priority under the slot allocation regulation and the evidence of the summer 1999 slot allocation process, in which 26,000 slots, or the equivalent of some 120 aircraft movements a day, were retimed, suggests that airlines could have a reasonable expectation of improving their slots over time.

2.128. The slot situation we have described could, at best, allow an airline very gradually to establish a network of long-haul and feeder services at Gatwick. There is therefore some force in the view that the acquisition of CityFlyer and its slots would be the last opportunity for the rapid development of a significant hub. However, in considering whether the merger would foreclose competition from another hub operator at Gatwick, we need also to consider whether a second hub at Gatwick would be viable in the longer term.

2.129. Gatwick is a small airport in global terms. It has a single runway and, as can be seen from Table 5.38, it handles less than half the number of flights operating from Heathrow or Amsterdam (Schiphol) and less than one-third of the flights from Paris (Charles de Gaulle (CDG)), Frankfurt or most major airports in the USA. Of all these airports, only Chicago, with five runways and seven times the number of flights handled by Gatwick, has supported two significant networks operating at the same time. The recent history of Gatwick, with three failed attempts to establish a single significant network, gives us no reason to believe that two networks on a broadly similar scale would now succeed where they have not been possible elsewhere. Moreover, we do not believe that an airline would see commercial logic in developing a significant second network at Gatwick when Stansted is considerably less congested.

2.130. We cannot rule out the possibility of a second airline developing a series of inter-connecting services on a far smaller scale than BA's network. Although there is no obvious line of demarcation between a hub operation and a series of services scheduled to provide a degree of interconnection, we see the two forms of competition as fundamentally different in terms of their requirement for slots. The merger may preclude the rapid development of a major new hub at Gatwick, but the slots becoming available would seem to offer at least some potential for the development of a series of interconnecting services over time.

2.131. We have also considered whether, given access to CityFlyer's slots, another air-line might displace BA's network at Gatwick. Vigorous competition at that level could clearly have benefits to passengers. However, the scale of BA's network is such that displacement does not seem a realistic prospect and none of the evidence we have received suggests that other airlines wanting slots at Gatwick have ambitions on that scale.

2.132. We therefore take the view that while the merger would effectively preclude the development at Gatwick of a significant hub operator, there is, in any event, little real prospect of such a development at Gatwick on that scale. Nor do we consider it likely that a competitor of BA would aspire to displace BA as the main hub operator, even if CityFlyer's slots were available to it. However, there is clearly scope for airlines to develop competitive services on a different scale to BA and we do not rule out the possibility that these may include combinations of short-haul and long-haul services. If the merger were to proceed, the situation at Gatwick that we have described in paragraphs 2.118 to 2.131 would not, in our view, preclude the development of these forms of competition over time. But it would reinforce existing difficulties for airlines seeking access to Gatwick and, given BA's predominance at Gatwick and its strong position at Heathrow, we regard this as a cause for concern that we should consider further.

Night-time operation

2.133. As we have noted in paragraph 2.26, airline operations at Gatwick during the night-time period are restricted by quotas set by the DETR on both the number of aircraft movements and aggregate noise levels. The quotas are allocated between airlines by ACL on the basis of voting power percentages (VPPs) calculated according to a formula agreed locally at Gatwick. The formula is described in Appendix 4.4. A key feature is that airlines receive allocations in accordance with the overall level of their activity at Gatwick rather than on the basis of their historic levels of night-time activity. CityFlyer, which has a substantial level of activity during the day, receives a substantial initial allocation of night noise quota and night movements which, because of the short-haul nature of its services, it does not require. Charter operators on the other hand have a substantial level of night-time activity but receive a relatively small allocation in line with their relatively low share of overall activity. Long-haul operators also have a need for night quotas to accommodate the typically early morning arrival of their services. Currently the system relies on airlines such as CityFlyer handing back their quota allocations to a pool for reallocation to those who need them.

2.134. The charter airlines raised a number of concerns with us both about the present allocation system and about the effect of the merger (see paragraphs 7.10 and 7.20). Their principal concern was that, with the transfer of its long-haul services to Gatwick, BA's need for night quotas is increasing and that, if the merger were to proceed, it would use the quota allocations currently handed back by CityFlyer. It was felt that, even if BA had no immediate need for its full allocation of noise quota, night movements and associated slots, it could disrupt the operations of other airlines by being slow to hand back its surplus. The charter operators emphasized that night movements were vital to allow them to operate the third daily rotation of their aircraft that made their operations at Gatwick viable. They told us that

a proposal was in preparation that would change the allocation formula to reflect more closely historic need for night-time movements but they feared that BA and its subsidiaries and franchisees would use their combined vote on the Scheduling Committee (see paragraph 4.62) to block the proposal. One airline was concerned that even the proposed allocation system would be problematic mainly because it would make inadequate allowance for the additional noise quota required to enable the charter operators to increase the size of their aircraft (see paragraph 7.21). It was also concerned that the proposal envisaged trading in entitlement to night operations which would favour larger airlines such as BA.

2.135. BA told us that, since it currently underused its own allocations of both noise and night movement quotas and was likely to continue to do so for the foreseeable future, the merger would have no effect on the availability of night noise quotas and movements or slots in the night period at Gatwick. Nor, in BA's view, would the merger have any effect on delays in the handing back of slots. It considered the use of such delays as a strategic weapon against other airlines to be slot abuse. It emphasized that it was not guilty of this kind of practice which was, in any event, monitored at Gatwick by a Slot Performance Committee and punishable ultimately by the expulsion of an airline from the airport.

2.136. As we show in Table 5.44, CityFlyer handed back over 90 per cent of its noise and movements quotas for the summer 1998 season. BA also handed back some 40 per cent of its noise quota and nearly 70 per cent of its movements quota. Table 5.45 shows BA's plans for the period up to 2001 and its more speculative forecasts for the period to 2007. Although these plans involve an increase in the size of BA's fleet at Gatwick and in its night movements, the use of quieter aircraft will reduce its requirement for noise quota. Even for 2007, it forecasts a requirement significantly lower than its own present allocation of both noise and movement quotas. However, the charter airlines which had made representations to us felt that these plans were only theoretical intentions, that they could change and that other airlines should not have to rely on the beneficence of BA for their continued operation at Gatwick.

2.137. We understand the charter operators' concerns about the present allocation system and the extent to which they have to rely on handed back quota. But our terms of reference require us to focus on the effects of the merger with CityFlyer. One issue raised by the merger is the effect on competition and consumer choice of BA using the quota allocation currently handed back by CityFlyer. But on the facts available this appears to us to be a purely hypothetical issue. Even allowing for a substantial margin of error, BA's historic usage of night-time noise and movement quotas at Gatwick, coupled with its plans for several years ahead, give us no basis for an expectation that it would exhaust its own quota in the foreseeable future. Moreover ACL told us that it had received legal advice that noise quota and night movements could be transferred between airlines. If this is so, it would be open to CityFlyer, with or without the merger, to give BA preferred access to the night-time allocations that it does not need so it is not evident that the merger would make any difference. Nor do we have any evidence that leads us to believe that BA would use the device of delaying the hand-back of CityFlyer's unwanted quota in order to disadvantage other airlines. We acknowledge that this is a theoretical possibility, but the absence of any firm evidence that BA has behaved in this way to date, coupled with the existence of procedures for monitoring and punishing slot abuse, mean that we have no basis for an expectation that it would happen in practice.

Availability of airport facilities

2.138. A number of concerns were put to us by other airlines about what was variously described as BA's privileged access to, control over, or stranglehold on, airport facilities at Gatwick and about the effect of the merger on that situation. There was a general fear that the merger would give BA greater voting power and influence over the allocation of these

facilities. There were more specific concerns about the allocation of piers and washing and parking stands for aircraft, the selection of ground handling agents, BA's control of hangar space for wide-bodied aircraft and the threat of congestion at the North Terminal (from which all BA's flights operate) if BA were to transfer CityFlyer's operations there from its present base in the South Terminal (see paragraphs 7.27, 7.41, 7.89 and 7.90).

2.139. Management of the allocation of facilities at Gatwick is a matter for BAA's subsidiary GAL. BAA told us that GAL's task was to provide users with a common standard for essential facilities and significant resources were committed to identifying and addressing individual airlines' needs which tended to vary across the range of users. BAA said that, in an overall sense, the fair treatment of airport users was ensured by the Airports Act 1986 which in effect required the airport operator to manage the airport without pursuing unreasonable discrimination. It noted that airport users who considered that they were being unfairly treated had the ability to make a complaint to a variety of competition authorities, usually the CAA. The CAA told us that it had had no complaints at all about unfair treatment of users at the airport at least since 1996.

2.140. Paragraphs 4.89 to 4.97 set out GAL's approach to the allocation of various classes of facilities. It is clear that allocation is determined essentially by the airport management rather than by voting power of the airlines. Where the airlines are involved, it is on a consultative basis. Although the allocation process is not formally linked to the number of aircraft movements or the VPP formula used for allocating night movements (see paragraph 4.63), allocations, as BAA has confirmed, are broadly related to the scale of an airline's activity at Gatwick. We do not consider this to be an unreasonable approach and it is not one which, in our view, would lead to BA and CityFlyer receiving more favourable treatment after the merger than they do at present.

2.141. On specific issues, we note that BA receives pier service (see Glossary) in the North Terminal on a proportion of its flights that is lower than the average for users of that terminal and significantly lower than the average for its competitors in the South Terminal (see paragraph 4.93). Its overall allocation is clearly larger than that of its competitors but there is no evidence to suggest that that is anything other than a reflection of the scale of its activities. We do not consider that the allocation of airport facilities by reference to the scale of each airline's activities is, by itself, a cause for concern and we have no evidence that the merger would change the present basis of operation.

2.142. We note that the selection of ground handling agents is carried out under the terms of the EC ground handling directive¹ and that BAA's policy is that airlines should have a choice of agents or, where it does not compromise operational and safety standards, to carry out their own ground handling. We note too that the choice of ground handling agents at Gatwick has recently been increased. We do not see the merger as affecting this situation. Nor do we see it as having any significant bearing on the concerns expressed to us about the availability of hangar space for Boeing 747 aircraft.

2.143. As to the risk of congestion at the North Terminal, BA told us that, in operational terms, it already made sense for CityFlyer to transfer to the North Terminal. But it considered that this was not achievable since another airline would have to leave and there was no mechanism for compelling it to do so against its wishes. In this context, we note that, under the terms of its franchise agreement with CityFlyer, BA already has a form of obligation to use reasonable endeavours to arrange for the transfer of CityFlyer's operations to the North Terminal (see paragraph 3.51). We do not see the merger itself as significantly increasing the likelihood of this happening.

¹Council Directive 96/67/EC of 15 October 1996, OJ L272, 25.10.1996, p36.

2.144. Delta Air Lines raised the possibility that BA's own operations in the North Terminal would expand if it acquired CityFlyer's slots. However, for the reasons given in paragraph 2.105, we consider that, while there may be some changes in schedules arising from the merger, it is unlikely that this would have the net effect of a scaling down of CityFlyer's operations and an expansion of BA's own services. Indeed the opposite trend seems more likely.

2.145. In summary, therefore, we do not expect the merger to change the basis of allocation of airport facilities at Gatwick to the disadvantage of BA's competitors.

Provisional findings on the concerns raised by the merger

2.146. Provisionally therefore we have identified three areas of concern arising from the merger: the reduction in competition on certain of CityFlyer's routes, the strengthening of BA's slot portfolio and the further limitations on the potential for entry and expansion at Gatwick by BA's competitors. Three other areas that we have looked at—route diversity, the availability of night movements and night noise quota and access to ancillary airport facilities—do not raise concerns that require further investigation.

2.147. As noted in paragraph 2.89, we must now consider what may be expected to happen in the absence of the merger, and its implications. In this context CityFlyer submitted that the likely course of events if the merger were not to proceed, and the effect of those events on the public interest, were so difficult to foresee that we should assess the merger on its own merits without speculating on the alternatives. There is indeed a range of possibilities. But our normal practice in assessing whether a merger may be expected to operate against the public interest is to compare the outcome of the merger against what may be expected to occur in the absence of the merger whether or not this is subject to uncertainty.¹ We believe we should not base our assessment of the public interest on a comparison with the status quo if the evidence suggests that this would not continue in the event of the merger not proceeding. We therefore consider now what might be expected to happen if the merger were not to proceed.

Alternatives to the merger

2.148. There are two factors that are of particular significance to our consideration of the alternatives to the merger. The first is that, as we note in paragraphs 3.71 and 3.72, the proposal for a merger came about because the institutional shareholders of CityFlyer wished to realize their investments in the business. [

Details omitted. See note on page iv.

]

The second factor is that CityFlyer has had a close commercial relationship with BA almost throughout its existence. It relies substantially on the marketing services of BA, operates under the BA brand and receives a substantial proportion of its revenue from passengers transferring to or from BA flights. These are likely to be important considerations for any potential purchaser of CityFlyer who could not be assured of the continuation of the BA franchise.

¹See, for example, *The Peninsula and Oriental Steam Navigation Company and Stena Line AB: a report on the proposed merger*, HMSO, Cm 3664, November 1997, paragraphs 2.170 to 2.179; and *Bass PLC, Carlsberg A/S and Carlsberg-Tetley PLC: a report on the merger situation*, The Stationery Office, Cm 3662, June 1997, paragraphs 2.45 to 2.50.

2.149. As we note in paragraph 2.44, [
Details omitted See note on page iv.

] Virgin Atlantic, however, submitted that it had been interested in buying CityFlyer from the outset.

Acquisition by Virgin Atlantic

2.150. On 1 March 1999, during our inquiry, Virgin Atlantic sent a written offer to buy CityFlyer, if BA were not allowed to do so, on the same terms and for the same price as had been agreed with BA. The CityFlyer shareholders told us that they considered that [
Details omitted. See note on page iv.

]. An account of the exchanges between CityFlyer and Virgin Atlantic on this matter is given in paragraphs 3.82 to 3.84. Virgin Atlantic told us that [
Details omitted. See note on page iv.

].

2.151. Virgin Atlantic believed that the acquisition would give it an opportunity to develop a hub at Gatwick. It said that, on the long-haul side, it had a requirement for two or three additional services a year and considered that the acquisition would meet its needs in that respect for a number of years to come. In relation to short-haul, it would discuss the options with CityFlyer's management and its sister company Virgin Express. It would expect to charge lower fares than BA and regarded the introduction of low-cost no-frills services as a possibility. But it intended to maintain the commercial viability of CityFlyer and had the option of operating the company's services under the Virgin brand or of allowing it to trade under its own names. Virgin Atlantic did not see its requirement for slots for long-haul services as inevitably leading to a reduction in CityFlyer's short-haul services. It believed that the larger pool of slots that it would acquire with CityFlyer would give it more options for taking advantage of slots becoming available under the normal slot allocation process at Gatwick.

2.152. [
Details omitted. See note on page iv.

Details omitted. See note on page iv.

]

2.153. If Virgin Atlantic were to acquire CityFlyer, we would expect it to use some of CityFlyer's slots to provide new long-haul services. We have taken account of the fact that CityFlyer's slot portfolio would also give Virgin Atlantic greater scope to make use of new slots becoming available under the normal slot allocation process, but it is unlikely in our view that Virgin Atlantic would be prepared to rely wholly on such slots for the purposes of implementing its long-haul plans. Virgin Atlantic's record and its recent applications for slots (see Appendix 5.10) reinforce our view that long-haul services remain the company's first priority and we would not expect it to leave CityFlyer's schedules intact until suitable new slots became available.

2.154. Virgin Atlantic's intentions in relation to short-haul services are less clear. The volume of CityFlyer's slots and the fact that many of them are specifically selected for short-haul use lead us to the view that, in the short term at least, Virgin Atlantic would continue some form of short-haul service, whether of the no-frills type or on the model currently provided by CityFlyer. But we consider it unlikely that a second significant short-haul network would be sustainable at Gatwick (see paragraphs 2.128 to 2.132). Moreover, with a few exceptions, the routes currently served by CityFlyer would not seem to be the obvious short-haul priorities for an airline such as Virgin Atlantic which currently has virtually no short-haul operation and a limited range of long-haul services at Gatwick. Virgin Atlantic might be expected instead to concentrate on denser short-haul routes capable of providing most feed to its long-haul services or a profitable volume of point-to-point passengers.

2.155. Virgin Atlantic's acquisition of CityFlyer would clearly avoid our concerns about BA's acquisition of a larger pool of slots. The potential for CityFlyer's slots to be used in competition with BA would also be preserved. The extent to which competition for BA would be increased in practice is less certain. Competition on some long-haul routes is constrained by the terms of ASAs rather than the unavailability of slots; and certain other long-haul routes are already subject to a significant degree of competition. However, we consider it reasonable to conclude that new long-haul services from Gatwick would provide some additional competition for BA, at least on some routes from Gatwick or Heathrow.

2.156. We are not convinced that Virgin Atlantic's intended use of CityFlyer's slots would maintain competition to BA on the routes on which the loss of competition between BA and CityFlyer has been identified as a cause for concern (see paragraph 2.102). We do not rule out the possibility that Virgin Atlantic would retain some of CityFlyer's services, but in terms of total passenger traffic from Gatwick, the routes of concern are among CityFlyer's thinnest routes (see Table 5.20). These are not the kinds of dense routes on which we would expect Virgin Atlantic to concentrate its resources. However, we consider it likely that at least some further competition would be provided to BA on other short-haul routes, albeit that this is likely to be on thicker routes where, in some cases, there may already be significant competition.

2.157. By the same token, we consider that Virgin Atlantic's acquisition of CityFlyer is unlikely to preserve the same degree of route diversity as the merger with BA. CityFlyer's main function within the BA network if the merger were to proceed would be to continue its present role of operating with smaller aircraft, and at lower cost, than BA so as to provide feed profitably from routes that are too thin to be profitable for BA's mainline operations. We would expect CityFlyer's priorities under Virgin Atlantic ownership to be different and this view was shared by others (see paragraphs 7.33 and 8.20). In our view, this puts the future of a number of CityFlyer's existing services (in particular those on the thinnest routes but including also those to Newcastle, Jersey and Guernsey) in some doubt. If BA were unable to acquire CityFlyer it might wish to introduce its own services to certain of the CityFlyer destinations but this may be at the expense of other services including potentially services to UK destinations (see Appendix 6.1). We therefore believe that the acquisition of CityFlyer by Virgin Atlantic would give rise to concerns about the loss of route diversity, including possibly a loss or reduction of air services to destinations in the UK and the Channel Islands.

2.158. Virgin Atlantic submitted that, if it were to acquire CityFlyer, benefits to the public would arise in the form of speed and ease of intralining since, unlike BA, it operated from the same terminal as CityFlyer. We accept that this would be a benefit to intralining passengers. However, given that BA currently serves over 70 destinations from Gatwick (see Table 5.23) against seven planned by Virgin Atlantic for the summer 1999 season (see Appendix 5.10), our expectation is that many passengers would continue to wish to connect with a BA flight. The coordination of ticketing, scheduling and transfer arrangements for these passen-

gers that derives from the franchise relationship between BA and CityFlyer would only be likely to continue if CityFlyer were to remain as a franchisee of BA but, given the competitive relationship between BA and Virgin Atlantic, we do not consider that to be a likely outcome; and for the same reason, we consider it doubtful that comparable arrangements would be put in place. All other things being equal, that would in our view be a less advantageous outcome as far as consumers are concerned than the consolidation of the existing interlining arrangements between BA and CityFlyer.

2.159. We consider the acquisition of CityFlyer by Virgin Atlantic to be a real possibility and we would expect that, if that were to happen, it would avoid certain of our concerns about the merger and would be likely to introduce a degree of competition for BA that would not exist if the merger were to proceed. Against this it would raise other concerns about a possible loss of route diversity and, of lesser significance, about the loss of coordination in interlining arrangements affecting passengers on a potentially substantial number of services from Gatwick. However, there are uncertainties about Virgin Atlantic's intentions, and about the commercial logic of its acquisition of CityFlyer, that lead us to the view that, while it is a possibility, this is not an outcome that we can actually expect to occur. We therefore need to consider other possibilities.

Acquisition by a major EEA airline

2.160. If neither BA nor Virgin Atlantic were to acquire CityFlyer, there is a range of other possible outcomes [

Details omitted. See note on page iv.

].

2.161. As control by persons who are not nationals of the EC or EEA would prevent CityFlyer from operating as an EC airline, it seems unlikely that any non-EEA airlines would seek to acquire CityFlyer.

2.162. Another major EEA airline may see value in CityFlyer's slots as a means of reinforcing services between London and its own hub in Continental Europe but we do not believe that it would find it commercially logical to operate the range of services from Gatwick currently operated by CityFlyer. While the acquisition of CityFlyer by such an airline may therefore be expected to ensure further competition for BA on certain dense routes to European hubs, it would in our view be likely to lead to a loss of CityFlyer's current services between Gatwick and UK destinations and to a more general reduction in route diversity.

Acquisition by a potential franchise partner for BA

2.163. We do not rule out entirely the possibility of CityFlyer being acquired by an independent investor or airline which BA would find acceptable as a franchise partner. Such an outcome would avoid the concerns raised by the merger with BA as the potential for airlines to compete with BA in future would be largely preserved. It would also be less likely than any other alternative to the merger to lead to a reduction in the diversity of routes served and it would preserve current arrangements for connecting passengers. However, if there were no prospect of BA acquiring CityFlyer in the future, potential independent investors would face uncertainty both as to BA's future commitment to its franchisee and as to the sale value of the business at the point at which they wish to realize their investment. An existing BA franchisee, or another airline with the potential to be a franchisee, may see value in CityFlyer's business for the longer term but such airlines are likely to be relatively small and

the acquisition of CityFlyer would be a major commitment particularly against the background of a previous adverse decision that BA could not acquire the business. In the circumstances, we do not regard the acquisition of CityFlyer by a potential franchisee of BA as a likely outcome.

Other possibilities

2.164. If, in the absence of any prospect of a sale to BA, the value of CityFlyer's business were to fall, the acquisition of the business essentially for the purposes of exploiting a limited number of its slots and exchanging or trading in the rest could not be ruled out although the present and future status of slot trading is uncertain. Our expectation is that, if this were to happen, some of CityFlyer's slots would be acquired by BA and certain of the concerns we have identified in relation to the merger would remain. Against this it is probable that at least some of CityFlyer's slots would be used to provide further competition to BA. However, if CityFlyer's slot portfolio were dispersed to the point where the company ceased to be a viable operation, the prospect of air services being preserved on thinner routes would in our view be reduced, and a low-cost component of BA's network would have been eliminated.

Conclusions on alternatives to the merger

2.165. In summary, if the merger with BA were not to proceed, any of a range of possible alternative outcomes might arise. However, the relationship between CityFlyer and BA is such that none of these outcomes has an obvious commercial logic which would suggest that it is an outcome that could be expected. On the evidence available to us, we consider that no single course of events from among the range of possibilities is sufficiently likely to occur to be regarded as the probable outcome. Taking the possibilities together, we expect that, in the absence of the merger, there would be an outcome which, one way or another, provided BA with a smaller holding of slots and maintained a greater level of actual and potential competition at Gatwick than would otherwise be the case. Against this, we expect that there would be little, if any, effect on competition on the routes on which the loss of competition between CityFlyer and BA is of concern to us (see paragraph 2.102). The route diversity that derives from the breadth of BA's network would also be reduced with a possible further loss of competition on the routes from which services are withdrawn; and there would be some loss of convenience to connecting passengers.

2.166. We draw three conclusions from this stage of our analysis. The first is that we do not need to pursue further our specific concern about the slight loss of competition on the routes served by CityFlyer. Given the current relationship between BA and CityFlyer, the loss of actual competition would be slight. There would be a loss of potential competition and this is of concern to us in relation to two routes where competition is weakest. But, in the absence of the merger, we would expect additional competition for BA not to be focused on those relatively thin routes but on thicker routes. In practice therefore the loss of actual and potential competition on these routes that would be attributable to the merger would be insignificant.

2.167. Secondly, the alternatives to the merger are likely to have effects on route diversity and arrangements for connecting passengers that we must take into account in assessing the balance of the public interest. We return to this matter in paragraph 2.189.

2.168. Finally, we have concerns about the increase in BA's slot portfolio and about the restriction of potential competition at Gatwick that is attributable to the merger. However,

before deciding what weight to give to these concerns in our assessment of the public interest we need to consider how far they are mitigated by the general competitive pressures on BA.

Competitive pressures on BA

2.169. We have described in paragraphs 2.106 to 2.132 why we believe that the acquisition of control of CityFlyer's slots would strengthen BA's competitive advantage over other airlines and add to existing constraints on the potential for BA's competitors to develop their operations at Gatwick. Our underlying concern in both cases is that BA may, as a result of the merger, be able to exploit a position of strengthened market power so that passengers have to pay higher fares, or receive a lower quality of service than would otherwise be the case. Whether this would happen in practice depends on the extent of the actual or potential competitive pressures for BA.

2.170. On the surface, BA's share of passengers on the 214 routes that it currently serves from Gatwick and Heathrow (see Table 5.31) suggests that it is well placed to achieve or consolidate a position of strength on a significant proportion of those routes. It is the only airline operating on 61 per cent of the routes it serves from Gatwick and on 21 per cent of its routes from Heathrow. Taking routes to common destinations from Gatwick and Heathrow as a single route, BA carries 50 per cent or more of the passengers on 62 per cent of those routes and is the only operator on 22 per cent of them.

2.171. However, shares of passengers carried are not, by themselves, a reliable indicator of market power in air services. Some of the routes on which BA has a monopoly are certain to be too 'thin' to attract a second operator in the short term. As we show in Table 5.32, one-third of all routes from Gatwick carried less than 50,000 passengers in 1998. This compares with 63,000 on the thinnest of CityFlyer's routes and with volumes of around half a million on dense routes such as Amsterdam and Dublin. If BA were to strengthen its presence on such thin routes, the benefits to passengers, in terms of schedules, could be substantial with very limited effects on competition. Equally there are routes on which an increased presence by BA could stimulate rather than inhibit competition; and some of the densest and most profitable long-haul routes on which BA may wish to strengthen its position are also among the most fiercely contested. On certain other routes, entry by BA's competitors is likely to be restricted by the terms of an ASA and although this may, subject to other controls imposed under the ASA, provide increased scope for the exploitation of market power, it is not a situation that could be attributed to the merger.

2.172. BA submitted that its actions were, in any event, constrained by new entry and the threat of new entry. It is certainly the case that regulatory barriers are low on the liberalized short-haul routes to EEA destinations. However, competition on these, as on long-haul routes, is constrained by the limited availability of slots. The situation at Gatwick is described in paragraphs 2.118 to 2.132. Some slots are available, but the development of new, effective, competition for BA is likely to be a gradual process, particularly if BA and its subsidiaries are competing for any slots that become available. We believe that access to slots at Gatwick for BA's competitors is such that the threat of rapid new entry is, at best, limited; and we do not believe that the position at Heathrow is any better. There is a greater competitive threat from airlines already holding slots at these airports who may be prepared to switch them to other routes if BA is seen to be making excessive profits on those routes. However, here too the threat is limited by the need for the airlines concerned to sacrifice other services.

2.173. There is more scope for entry at Stansted, Luton and City airports. For the reasons given in paragraphs 2.61 to 2.69, we believe that services from these airports are

likely to provide a degree of competitive pressure on BA's operations at Gatwick and Heathrow. But this pressure may be selective. In the absence of any scheduled long-haul operations or a significant network of short-haul feeder services, the smaller London airports do not currently provide a significant threat to BA's services to connecting passengers. It is clearly open to BA's competitors to introduce interconnecting services at one or other of these airports and, as noted in paragraph 5.46, the suggestion has been made that long-haul flights could operate into Stansted within the next few years. However, we believe it would take time and a substantial commitment for a competitor to develop a hub operation that could pose a significant threat to BA and we do not expect this to happen in the near future.

2.174. There is a more immediate threat to BA from airlines using the smaller London airports to provide services on routes that could be sustained largely by point-to-point traffic. Services from these airports, and in particular the no-frills operators, are, in our view, capable of providing a significant competitive constraint on BA's fares for leisure passengers. The evidence that they can compete to similar effect for the more time-sensitive business passengers is not strong. Differences in catchment area are likely to give BA a significant degree of protection in this segment of the market which can also be insulated to some degree from the competitive pressure affecting the leisure market by BA's fare structures. However, we accept that there is potentially real choice for BA's business customers starting their journeys in central London and that BA is therefore not immune from new competition from the smaller airports.

2.175. Competition from alternative hubs is also a potential constraint on BA's conduct. As we illustrate in paragraphs 5.215 to 5.229, passengers travelling from parts of the UK outside south-east England and from starting points in Continental Europe have an array of alternatives to the use of Gatwick or Heathrow for travel to both long-haul and European destinations. BA's competitors are actively seeking to attract UK-originating passengers to their hubs as an alternative to Gatwick or Heathrow and data based on a recent International Passenger Survey (see Appendix 5.8) suggests that some 39 per cent of passengers starting long-haul journeys in five of the UK's major airports outside London used Continental hubs rather than Gatwick or Heathrow to connect to their long-haul flight. Although transfer passengers account for a minority of BA's passengers, we believe that they are sufficiently important in terms of their overall contribution to revenues to BA's network to be a potentially significant influence on the company's commercial policy. On its services from Gatwick, for example, BA estimated that some 22 per cent of revenue from its various routes is accounted for by passengers transferring from other BA services. However, here, too, we believe that there is scope for BA to reduce the competitive influence of other hubs on the generality of its passengers by the use of fare structures that differentiate between transfer and point-to-point passengers.

2.176. More generally, BA told us that the number of routes on which it faced competition from more than one airline was increasing and that its average yields on domestic routes had fallen by 12 per cent since 1993/94 although, as we illustrate in Tables 5.29 and 5.30, there is a significant difference in the trends of average yields and those of yields from fully flexible fares which, on the overlap routes at least, have generally risen in real terms. Moreover, as we note in paragraph 5.111, the effect of frequent flyer programmes and potentially also of loyalty schemes for travel agents, both of which are operated by BA, may help to maintain higher prices and, although CityFlyer already participates in BA's frequent flyer programme and will add proportionately very little to BA's business with travel agents (see paragraphs 6.76 and 6.191), the merger may be expected at least to consolidate the existing effect of these programmes.

2.177. Whilst levels of competition for BA are likely to vary route by route, the evidence available suggests that, in general, there are significant competitive pressures on BA, including pressures from outside Gatwick and Heathrow, in certain market segments. We believe that the no-frills operators will continue to exert a significant competitive influence in relation to point-to-point travel for leisure purposes; and we are satisfied that there is substantial competition for BA's connecting passengers from airlines operating the major hubs in Continental Europe. But we believe that the competitive pressure on BA in relation to point-to-point business travellers and others who require fully flexible fares are weaker and more dependent on access to Gatwick and Heathrow. We accept that the continuing rapid growth of the three smaller London airports may increase their competitive influence in the time-sensitive business travel segment of the market in the longer term. However, there are currently clear limitations on competition from these airports, arising from their relatively small scale, their different catchment areas and the different kind of service offered by the no-frills operators. This leads us to the view that, in the point-to-point business segment, the strengthening of constraints on access to Gatwick is likely to have at least some impact on competition which will not be offset by competitive pressures from other sources. We believe that this may be expected adversely to affect fares for an important section of the travelling public. However, before reaching our conclusion as to the balance of the public interest, we first consider whether the merger may be expected to have any public interest benefits.

Benefits of the merger

2.178. We need to take into account two types of benefit of the merger. First, in considering alternatives to the merger, we have identified certain concerns that would arise only if the merger were not to proceed. The avoidance of these concerns can be regarded as a benefit of the merger. Secondly, we need to consider whether the merger would have any other benefits which are unlikely to arise from any of the alternatives to the merger. There is a degree of potential overlap between these two types of benefit and we take this into account in our analysis.

2.179. CityFlyer and BA put it to us that one of the benefits of the merger was that it would preserve the existing franchise arrangement which itself was beneficial to consumers. In particular, the mutually supportive nature of the arrangement between CityFlyer and BA and the mutual benefits of feed between their respective services would allow BA to continue to operate services on routes that would otherwise not be viable. This contributed to diversity of routes and choice for consumers. Connecting passengers benefited from the convenience of the transfer arrangements between BA and CityFlyer flights and from the assurance of BA's service standards on interconnecting flights. There was, moreover, a wider benefit to the public, to the achievement of goals in UK transport policy and to employment in the Gatwick area from preserving arrangements which allowed BA to develop Gatwick as an international hub where other airlines had previously failed. BA also told us that the merger provided better opportunities for BA and CityFlyer to exploit scheduling synergies at Gatwick (see paragraph 6.84) and that this would be likely to improve results by up to £[~~30~~] million a year by 2001.

Intralining

2.180. By comparison with transfers between different airlines, intralining—the use of the same airline on each leg of a journey—typically provides connecting passengers with the added convenience of through-ticketing and baggage handling, better coordination of schedules to minimize waiting times and the prospect of special arrangements to speed up a

transfer if there is a risk of a connection being missed. There was a consensus among those who gave evidence to us that passengers prefer this sort of arrangement.

2.181. Under their franchise arrangement BA and CityFlyer are able to provide most of the benefits of intralining for their connecting passengers. To the extent that these benefits would be lost if the merger were not to proceed (see, for example, paragraph 2.158), we recognize that the merger would be a benefit. We also recognize that present arrangements between CityFlyer and BA for the coordination of transfers might be improved further if the two companies were under common ownership. However, we are not convinced that intralining, or similar arrangements for transfers between the flights of franchise partners, are of such value to consumers as to outweigh the advantage that competition brings in terms of lower fares or a higher quality of on-board service. While, therefore, we recognize the preservation and improvement of the existing arrangements for transfers between BA and CityFlyer flights as a benefit of the merger, it is in our view a modest benefit which could not compensate for a loss of effective competition and higher fares.

Route diversity

2.182. Neither BA nor CityFlyer have put it to us that the merger would result in an overall increase in the number of routes currently served from Gatwick. Nor have they offered an assurance that all their present routes would be maintained. However, both have emphasized that the present mutually supportive relationship between their respective services was important if the network of routes that could be served profitably was to be maximized.

2.183. For the reasons given in paragraph 2.105, we do not believe that the merger would itself bring about a reduction in the diversity of routes served. On the other hand, if the merger were not to proceed we would expect some loss of diversity to arise, including possibly a loss of services from Gatwick to destinations in the UK and Channel Islands (see paragraphs 2.153, 2.154, 2.162 and 2.164). In our view there are advantages to the public interest in maximizing the network of services that can be provided profitably and we accept that a network of services coordinated to maximize feed between services allows the profitable operation of routes that would otherwise not be viable. Moreover, as we note in paragraph 4.55, the provision of adequate air services to and from the UK regions is one of the Government's current policy objectives for aviation. In the circumstances we consider the avoidance of a reduction in route diversity that would be likely to occur if the merger were not to proceed to be a benefit of the merger.

The development of Gatwick as an international hub

2.184. We also see some force in the view that the mutually supportive arrangement between BA and relatively low-cost operators such as CityFlyer have contributed to BA's ability to build and sustain a network of services at Gatwick where others have failed. Given that Heathrow is full, it is clearly desirable that Gatwick should flourish as an international airport with an extensive network of connecting flights. BAA told us that it regarded BA as an important customer whose presence at Gatwick was important to the future development of the airport.

2.185. BA told us that although its operation at Gatwick was beginning to move into profit, it was still marginal with a return on capital still well below the publicly stated target for the group as a whole (see paragraph 3.40). It believed that if the merger were not allowed to proceed it would be a serious setback for the further development of the Gatwick hub.

Certain of CityFlyer's routes were particularly important to the BA network and would be replaced by BA services or those of one of its subsidiaries, but other routes would have to be sacrificed to provide the additional slots and aircraft required (see Appendix 6.1).

2.186. It is an important consideration that CityFlyer's operations are, in effect, an existing part of BA's network. If the present degree of integration of CityFlyer's services with BA's network were lost, there could be a reduction in the level of feed for BA's own services, in the attractiveness of arrangements for connecting passengers and in the range of connections available. The scheduling synergies referred to in paragraph 2.179 would also not be available in the absence of the merger. We have no basis for suggesting that BA could not survive without CityFlyer but the loss of the relationship with CityFlyer would, inevitably in our view, have at least some adverse effect on the economic viability of BA's operations at Gatwick. We therefore see the removal of uncertainty about the future of a part of BA's network, and about the viability of BA's hub at Gatwick, as a benefit of the merger.

Employment

2.187. We are also mindful of the potential benefits in terms of the maintenance of employment, both in CityFlyer and BA and in the provision of ancillary services that the merger would provide. The use that would be made of CityFlyer's slots in the absence of the merger could provide alternative employment at Gatwick. But the scope for this is unclear and the implications of an alternative that leads to the break-up of CityFlyer's business are particularly difficult to predict. However, the probability is that some form of employment would be created by the use of CityFlyer's slots. In the absence of any evidence that overall employment opportunities would be reduced if the merger were not to proceed we do not believe we should regard the maintenance of employment as a benefit attributable to the merger.

2.188. We now weigh these benefits against the concerns identified in paragraphs 2.166 to 2.168 to arrive at our conclusion as to the balance of the public interest.

Assessment of the public interest

2.189. The commercial logic of the existing franchise arrangement between BA and CityFlyer is clear to see. CityFlyer told us that it had recognized from the outset that it would need a close relationship with a major airline to operate profitably. The relationship with BA has been successful for CityFlyer. It has grown rapidly and it is profitable. BA too has benefited. CityFlyer's lower costs have allowed BA to extend its network to routes that might not otherwise have been viable from Gatwick and to obtain valuable feeder traffic which underpins the viability of its own services. There have been benefits to passengers in the form of access to a wider range of destinations, more attractive schedules at Gatwick and the ability to interline with some security that the service and safety standards of the interlining partners will be comparable. Franchising relationships such as that between BA and CityFlyer have also played a significant part in developing Gatwick as an international hub whereas it has previously struggled to sustain a credible network of international scheduled services. It is therefore not surprising that BA felt it desirable to bid for CityFlyer to preserve the existing synergies between the two companies when it became clear that CityFlyer's shareholders wished to exit the business.

2.190. However, the merger clearly raises a number of concerns. To the extent that CityFlyer is currently free to serve its own interests in choosing its routes and setting its schedules and fares, the transfer of full control to BA would diminish competition between

the two companies. But the closeness of their relationship and the conditions of competition on the overlap routes suggest that the reduction in competitive pressure for BA on these routes would be very limited; and as we note in paragraph 2.166, we do not consider it likely that this situation would, to any appreciable extent, be avoided if the merger were not to proceed.

2.191. On the other hand, BA has a position of considerable strength relative to other airlines on the routes it serves from Gatwick (see paragraph 2.170). There are a variety of reasons why other airlines at Gatwick are unable or unwilling to provide more competition to BA on these routes. Some airlines are able to compete from Heathrow. In some cases, the routes are too thin to sustain more than one operator. In others, entry is likely to be restricted under the terms of ASAs. But difficulty in obtaining slots is clearly an important factor and, if the merger were to proceed, an opportunity for BA's competitors at Gatwick to improve their access to BA's markets would be lost.

2.192. BA's acquisition of a larger portfolio of slots and services would give it extra flexibility that would strengthen further its competitive position relative to other airlines. In terms of BA's ability to respond more quickly than competitors to new opportunities or competitive threats, we believe that the incremental effect of the increase in its overall holding of slots at Heathrow and Gatwick would, in itself, be limited. However, in circumstances where slots are difficult to obtain and there is such a large gap between the size of BA's slot portfolio and that of the next largest competitor at Gatwick (see Table 2.2), it is in our view likely that the erosion of BA's advantage by its competitors will be even more difficult as a result of the merger and we would expect this to lead ultimately to a loss of effective competition.

2.193. The foreclosure of the competition that other airlines could provide using CityFlyer's slots is also a cause for concern. Potential competition for BA is already restricted by slot constraints at Gatwick but the constraint would be increased if BA were to take control over CityFlyer's slots. In the absence of the merger, we believe that there would be some competition on both short-haul and long-haul routes that would not exist if the merger were to proceed. The loss of this potential competition at Gatwick would be mitigated to some extent by a number of factors. Airlines holding existing slots at Gatwick or Heathrow are a potential source of competition for BA. Competition from the no-frills operators at the smaller London airports is affecting at least certain segments of BA's market; and hub competition from its major European competitors is providing competitive pressure on fares for transfer passengers. However, we are not convinced that these competitive pressures are feeding through adequately to all classes of passenger. Time-sensitive passengers in particular have relatively limited flexibility as to their choice of airport and there is no clear evidence that those using Gatwick and Heathrow have benefited significantly from low-cost services from Stansted and the other smaller London airports. We therefore take the view that while there is clearly a range of competitive pressures on BA, these by no means mitigate entirely our concerns about the loss of potential competition at Gatwick that would arise if the merger were to proceed.

2.194. The main benefit to take into account in deciding on the public interest relates to route diversity. This was a concern of a number of parties who made representations to us. Their belief was that a loss of route diversity was more likely if the merger were to proceed than if it were not to do so. For the reasons given in paragraphs 2.105 and 2.165, we take the opposite view. In our judgment, while the merger is not likely to affect the level of route diversity provided by BA or CityFlyer, some reduction in that diversity might be expected to occur if the merger were not to proceed. The merger would also help to maintain the viability of BA's hub operation at Gatwick with benefits to the development of Gatwick as an alternative international hub to Heathrow and to consumer choice.

2.195. As noted in paragraph 2.181, while the merger might be expected to preserve the benefits of intralining for more passengers than would be the case in the absence of the merger, we are not convinced that most travellers would regard this as more important than competitively determined fares and we therefore regard it as at best a modest benefit.

2.196. Weighing up these factors, we find that the benefits and detriments of the merger are very finely balanced. Overall, our judgment is that the benefits of the merger are not sufficient to offset fully our concerns about the increase in BA's competitive strength and the reduction of potential competition at Gatwick that would arise from BA's acquisition of CityFlyer's slots.

2.197. We conclude that the merger may be expected to operate against the public interest in that there would be a reduction of potential competition for BA which might be expected to lead ultimately to higher prices and a poorer quality of service than would otherwise be the case.

Remedies

2.198. As required by section 72(2) of the FTA, we have considered what action might be taken to remedy the adverse effects we have identified.

2.199. The detriments caused by the merger, referred to in paragraph 2.196, result essentially from the additional market power that BA would gain from its acquisition of CityFlyer's slots. These detriments arise in two different ways. First, the acquisition of CityFlyer's slots by BA would have the immediate effect of foreclosing the opportunity for BA's competitors to acquire these particular slots for the purposes of offering new services or expanding existing services, in competition with BA. These slots would also cease to be ones which might, in part at least, become available for recycling over time through the normal procedures for slot exchange and reallocation. In the second place, the acquisition of control over CityFlyer's slots would provide BA, already the largest holder of slots at Gatwick, with a larger and more varied portfolio of slots and services which would strengthen its advantage over its competitors. It would be able to absorb further slots more easily than its competitors in the course of the exchange and reallocation processes referred to above and to respond more quickly than they could to new market opportunities and competitive threats by virtue of being able to match slots to opportunities as they arose.

2.200. We consider that these detriments are partly, but not entirely, offset by certain benefits of the merger. We therefore now seek to identify remedies which would be relevant and proportionate to our overall assessment.

2.201. Where we have found that a merger may be expected to operate against the public interest because it strengthens market power, it is desirable in principle to look for a structural remedy to ensure that a competitive situation is fully restored. In that context, we first considered prohibition of the merger.

Prohibition

2.202. We have found it difficult to predict exactly what would happen to CityFlyer if the merger were not allowed to proceed (see paragraph 2.165). Preservation of the status quo

is unlikely and a number of alternative outcomes are possible. However, we would expect that, one way or another, there would be at least some competition that would not be possible if the merger were to proceed and BA's portfolio of slots would not be strengthened. Such an outcome argues in favour of prohibition. However, there are also substantial arguments against prohibition.

2.203. Prohibition would itself have adverse consequences. We recognize that if the merger proceeds there could be some switching of CityFlyer slots to long-haul BA flights which could reduce competition on short-haul routes and could reduce route diversity if some short-haul destinations ceased to be served. Against this are three points. First, our analysis of route profitability suggests that BA would be likely to reduce existing short-haul BA flights before CityFlyer ones if it wished to increase long-haul flights. Second, the CityFlyer network is an important element in BA's network out of Gatwick. If it were reduced significantly this would be likely to have quite a severe impact on BA's hub operation at Gatwick. Third, most alternatives to the merger would be likely to lead to a reduction in CityFlyer's short-haul network. Prohibition would therefore be likely to result in a reduction in route diversity. Though of less significance, it would also be likely to lead to the loss of the benefits of intralining or similar arrangements for a potentially significant number of passengers using Gatwick.

2.204. The increment to BA's power to manage its portfolio of slots in ways not open to other airlines operating at Gatwick is not in our view particularly large, but the erosion of BA's current advantage by its competitors would be more difficult. The loss of availability of slots to other airlines is more significant but this is to some extent offset by three factors. First, the loss of the franchise will itself be of some detriment to passengers. Second, if these slots are genuinely to be used to provide more competition, then this will entail the progressive dismantling of a successful short-haul network which, moreover, provides considerable feed traffic, de facto intralining and an important contribution to Gatwick as a hub. Third, such increases in competition as are likely would in our view tend to be in the denser routes which already tend, within ASA limits, to be very competitive. Route losses are likely to be thinner short-haul routes which need connecting passengers to be viable. We are persuaded that the overall result of the merger is, on balance, detrimental to the public interest, but not to the extent that prohibition could in our view be deemed a proportionate response. Moreover, we believe there are alternative remedies which are more appropriate to the net detriments identified.

Ring-fencing

2.205. As mentioned in paragraph 2.103, it was put to us that one outcome of the merger would be that BA would use CityFlyer's slots to provide services on more profitable long-haul routes. Some form of ring-fencing of CityFlyer's slots was proposed as a means of preventing the loss of diversity in short-haul routes served. In this context, we have concluded that, while BA may switch slots between services from time to time, this is not more likely to occur as a result of the merger. However, we have also considered whether ring-fencing might be successfully used to prevent BA from using CityFlyer's slots to strengthen its competitive advantage over other airlines. BA told us that its intention was to give CityFlyer's management a high degree of autonomy in the management and use of its slots and that it would be consistent with its plans for the company to confine their use to short-haul services. However, it believed that CityFlyer, like any other airline, should be allowed to exchange slots with BA as this ensured the efficient use of available resources. BA suggested instead that it could give an undertaking not to allow the overall value of CityFlyer's slots, calculated on an agreed basis, to fall below its current level.

2.206. Although, in principle, ring-fencing would address part of our concerns, it would raise a number of difficulties. We see no real virtue, in terms of benefits to competition, in restricting the use of CityFlyer's slots to short-haul routes. It would also be unsatisfactory from the point of view of efficiency to confine their use to CityFlyer's present routes or to prevent BA and CityFlyer from exchanging slots. Even if a satisfactory way could be found of denying BA access to CityFlyer's slots, it would not be possible to prevent it from influencing the way CityFlyer's management used the slots. BA told us that it would undertake not to do this but such an undertaking would not in our view be capable of being monitored or enforced. It would also be possible, and consistent with CityFlyer's current role, for CityFlyer to take over certain of BA's services, using its own slots and releasing BA's slots for other purposes. We do not therefore see ring-fencing as either a useful or practicable remedy. Nor would it address our concerns about the loss of potential competition at Gatwick.

Divestment

2.207. BA told us that, although it placed a value on CityFlyer's business that was substantially greater than the value of its slots alone, it would regard a requirement to divest all of CityFlyer's slots as the equivalent of prohibition because CityFlyer's ability to operate would have been taken away. BA also emphasized that, even with CityFlyer's slots, its overall share of slots at Gatwick would be substantially below the shares held by its major competitors at their own hubs in Europe (see Table 5.38). It submitted that if it was to be able to compete effectively on a global scale it would have to be allowed to develop its business at Gatwick. It had invested substantially in its hub operation at Gatwick, to the benefit of the airport's development, at a time when no other airline was prepared to do so. Its operations were now only just moving towards profit but return on capital was well below the published target for BA as a whole. BA should be allowed to recover its investment. Divestment would be a damaging limitation on its ability to develop.

2.208. A number of third parties who gave evidence to us expressed concern about BA's current share of slots at Gatwick and more generally about the difficulty of obtaining slots at Gatwick. However, it is beyond our terms of reference to contemplate remedies that deal with more general concerns about congestion at Gatwick and the scale of BA's hub operation, as opposed to the effect of the proposed merger.

2.209. As noted in paragraph 2.132, we do not consider that a second significant hub operation could be sustained at Gatwick. Nor, in our view, is it realistic to suppose that a remedy for the detriments arising from this merger could so change the balance between BA and its competitors as to open up an effective competitive challenge to BA from an alternative hub operation. It is also relevant in this context that it is not possible, within the terms of the EC slot regulation for UK authorities acting under the FTA, to direct that slots should be given up to a particular airline or for a particular class of air services.¹ We therefore take the view that any remedy should be aimed at ensuring that the generality of BA's competitors are not disadvantaged by the merger and are able, as far as is possible within the slot-constrained circumstances of Gatwick, to develop competing or complementary services alongside BA's hub operation.

¹The European Commission proposed in its notice on the BA/AA alliance (see footnote to paragraph 2.214) that in certain circumstances slots should be given by the alliance to competitors requesting them; but the slot regulation is expressed in the recitals, to be without prejudice to the competition rules of the Treaty—there is no equivalent provision in relation to UK competition law.

2.210. We do not consider that a requirement for the divestment of a proportion of the slots used by BA or its franchisees to provide their existing network of services would be a satisfactory way of addressing this issue. First, for the reasons we have rehearsed in paragraph 2.203, it would be likely to have the immediate adverse effect of a reduction in the diversity of routes served from Gatwick. Secondly, divestment could weaken BA's network, calling into question not just the future of individual routes but also the viability of parts of the network that rely substantially on feed traffic. Thirdly, an immediate return of a block of slots to the pool would not match the supply of slots to the readiness of airlines to use them and could be wasteful. It would, in any event, be impossible to control the use of slots returned to the pool or to predict whether their allocation would be fragmented or concentrated or whether they would be used to increase competition for BA or for some other purpose.

2.211. We are therefore faced with a remedy which, on the one hand, could be quite damaging to consumer choice and on the other hand would have largely unpredictable effects on competition. We consider that such a measure would not be a satisfactory or proportionate way of remedying the detriments we have identified.

Capping

2.212. As to the alternatives, BA submitted that many of the benefits of the operation at Gatwick, such as international competitiveness and network feed would be lost if significantly restrictive conditions were attached to the merger. It told us that it was extremely anxious at the prospect of any cap on its holdings of slots which did not permit even modest expansion. It suggested that parallels could be drawn with the EC competition case (see paragraph 2.123) involving a joint venture between Air France and Sabena in which the European Commission accepted that the two airlines should be able to hold up to 65 per cent of slots at Brussels Zaventem airport in any two-hour period and up to 75 per cent in a single hour. BA subsequently developed these views into a proposal for a series of measures that it could contemplate if the Commission considered it necessary to recommend that conditions should be attached to the merger. These proposals are set out in paragraph 6.107 and we have taken account of BA's reasoning underlying the proposals in developing our own recommendations.

2.213. Our own view is that the detriments can best be remedied by giving BA's competitors more scope to access the slots becoming available at Gatwick. The continuing modest increases in runway capacity, the occasional release of existing slots for reallocation and the priority given to the improvement of slots over time all provide airlines with at least some opportunity for new entry and expansion at Gatwick. A cap would provide BA's competitors with greater access to new slots than would otherwise be the case and, if set at the right level, would address the detriment we have identified in three ways. First, it would limit BA's ability to exploit the advantage it gains from being able to absorb less desirable slots into its large portfolio of services until they can be retimed so as to capture an increasing share of Gatwick's slots. Secondly, those of BA's competitors who wish to establish a stronger presence at Gatwick will have a better opportunity to develop their own portfolio of slots thereby eroding BA's competitive advantage; and thirdly the scope for direct competition for BA, particularly in relation to the point-to-point business segment of the market where services from the smaller London airports have, as yet, had least impact, would be increased.

2.214. In this context, it was brought to our attention that the European Commission had considered that, as a condition for allowing BA to proceed with an alliance with AA,¹ BA and AA might be required to reduce their flights, and associated slot holdings on certain routes from the UK to the USA so that competitors, collectively, would be able to build up services occupying 55 per cent of the frequencies on these routes. The European Commission said that it was necessary for the alliance's competitors to have a slightly higher proportion of the slots in order for competition to develop rapidly. This proposal addressed circumstances that were likely to arise on specific routes and the remedies envisaged are not necessarily the right ones to deal with the detriments we have identified. For the reasons already outlined, we do not consider remedies involving divestment to be appropriate. However, we believe it relevant to consider whether, as in the BA/AA case, a cap should leave room for competitors which, collectively, have a presence at Gatwick greater than that of BA.

2.215. We recognize that Gatwick is small by the standards of the airports in which BA's major European competitors are based and that the viability of a hub operation depends as much on the absolute scale of the operation as on the share of total slots available. However, BA has a major share of slots at both Heathrow and Gatwick and a growing presence at Stansted through its subsidiary Go. Even allowing for the duplication and inefficiencies that are built into the operation of separate hubs at Heathrow and Gatwick, the overall capability of BA and its subsidiaries and franchisees in London airports is already substantial and comparable to that of BA's major European competitors. We therefore consider that it would not damage hub competition if, in the short to medium term at least, Gatwick were to continue to accommodate operations by BA's competitors that, collectively, were slightly more substantial than those operated or licensed by BA.

2.216. The cap would clearly need to apply to both BA and its subsidiaries. But our concern about a cap applying only to BA and its subsidiaries is that it might simply result in more of BA's services at Gatwick being operated by franchisees who, by the nature of franchising arrangements, are likely to compete with BA to only a limited degree. This would, in our view, both undermine the intention of the cap and, potentially, distort BA's judgment as to the most appropriate type of operation to serve particular routes. This in turn could adversely affect the interests of passengers. We therefore believe that the operations of BA's franchisees should fall within the cap. We propose that slots used by those that are not also BA's subsidiaries on services licensed by BA should be subject to a limit and that any usage above that limit should count against the cap on BA and its subsidiaries. We note that this would not in any way restrict the ability of franchisees to operate services outside the franchise, under their own brands.

2.217. For the reasons given in paragraphs 2.136 and 2.137, we do not believe that the merger would give rise to detriments in relation to night-time operations at Gatwick. We therefore recommend that the cap should be related to slots available in the recognized day-time period of 0600 to 2330 local time (0500 to 2230 GMT in the summer season). We have considered whether this would lead BA to transfer more services from the daytime to the night-time. However, this is only likely to occur on the early morning boundary between the day and night periods and, given the extent to which BA currently underuses its entitlement to night-time operation, such transfers would be possible with or without the merger and we do not believe that they should now be subject to further restriction.

2.218. We recognize that both the slots available and individual shares of slots vary on a daily basis. We have therefore considered whether the cap should be related to daily, weekly or seasonal holdings. Our judgment is that a cap on BA's share of slots available in any one

¹Commission Notice concerning the alliance between British Airways and American Airlines, *Official Journal No C239*, 1998, Item 5 (98/C 239/05).

week would provide a satisfactory balance between flexibility and the aim of promoting adequate access for BA's competitors at all times.

2.219. We have also considered whether the cap should be set in terms of numbers of slots to be held or a percentage of slots available. Given that our rationale for the cap would be to encourage the potential for competition on a scale that is related to the size of BA's operation, we believe that the cap should be on shares of slots so that BA and its competitors have an equal opportunity to benefit from any growth in the capacity of Gatwick. We also take the view that a cap related to allocated slots would be difficult in practice to operate and enforce because slot allocations change frequently throughout a season. We therefore recommend that the cap should relate to total available slots (effectively total capacity).

2.220. As to the level of the cap, we believe that it should provide for potential competition from airline operations on a scale slightly greater than the current operations of BA and its subsidiaries and franchisees. We note that at the start of the summer 1999 season, BA, its subsidiaries and CityFlyer held just under 41 per cent of all available slots for the peak week and BA's other franchisees held just over 4 per cent (see Table 5.40). On that basis, we consider that BA and its subsidiaries should be capped at 41 per cent and BA's franchisees who are not also subsidiaries should be capped at 5 per cent with any usage above this figure being counted against the cap on BA and its subsidiaries.

2.221. As we show in Table 5.41 and Appendix 5.9, Table 1, BA and its subsidiaries and franchisees have a substantial share of slots at certain times of day. This appears to be a common characteristic of hub operations. We consider that it would be damaging to competition between Gatwick services and those at other hubs to require BA and its subsidiaries and franchisees to keep their shares at 41 per cent and 5 per cent respectively at all times of the day. However, we are concerned that the scope for entry and expansion by BA's competitors could be more limited than we intend if BA were to keep within the overall cap but to increase its already substantial holding of slots in the peak hours. We have considered whether this could best be prevented by a cap on holdings in single hourly periods or longer periods. We believe that there are peak hours in the morning and evening that are of such importance to short-haul operators seeking effective entry as to require an individual cap. At the moment the two periods concerned are 0700 to 0755 and 1700 to 1755 GMT but to avoid the possibility of the cap distorting the pattern of traffic we believe that there should be a cap at 70 per cent of available slots in any one hour. However, the 'shoulder' periods for the two peak periods are also in substantial demand and a 70 per cent cap would leave BA considerable room to increase its share of slots in those periods by sacrificing slots at less preferred times. We therefore propose that there should be a further cap of 65 per cent on the share of available slots in any two-hour period. These time-specific caps should apply to the total share of available slots used by BA, its subsidiaries and its franchisees.

2.222. As to the duration of the cap, we understand BA's desire to have as much freedom as possible to develop its hub operation as a competitor to those operating elsewhere in Europe and the USA. We have taken into account the need for that operation to be internationally competitive in deciding not to recommend prohibition of the merger and we do not believe that the cap we are proposing would undermine what BA has achieved at Gatwick to date. In order to remedy the detriments we have identified we need to create conditions which would help BA's competitors to develop a stronger foothold in Gatwick. Given the limitation on slots and the nature of the slot allocation system, this will be a gradual process and, in our judgment, the cap would need to remain in place for longer than the three- to four-year period initially put to us by BA. However, we cannot foresee either the pattern of demand at Gatwick or the pattern of competition for BA in the long term and we do not believe that an indefinite or long-term cap would be either desirable or necessary. We therefore recommend that the cap should remain in place up to and including the summer season of 2004. As the summer 1999 season is now under way and slot allocations are

largely settled, we recommend that the cap should not come into operation until the beginning of the winter 1999/2000 season.

2.223. On the basis of ACL's allocations of available slots as they stood at 28 March 1999, the caps we are recommending would not require the divestment of any slots by BA or its subsidiaries or franchisees. Although we would expect BA to adjust its schedules and services over time in accordance with the requirements of the market, the capping of BA's slot holding would not, in our view, provide any justification for the withdrawal of services. We also note in this context that, in the course of our inquiry, BA indicated that it was prepared to give an undertaking to retain services from Gatwick to destinations in the UK and Channel Islands currently served by CityFlyer.

2.224. In summary, we recommend that BA should be required to give undertakings that, with effect from 31 October 1999 and until the end of the summer 2004 season:

- (a) BA and its subsidiaries, including subsidiaries which are also franchisees, will not operate services that, in total and over the period of any one week, use more than 41 per cent of all slots available at Gatwick during the daytime operating period.
- (b) Any usage of slots by BA's franchisees, excluding those which are BA's subsidiaries, on routes licensed by BA that exceeds a total level of 5 per cent of all slots available at Gatwick during the daytime operating period will be regarded as slots used by BA or its subsidiaries and counted against the cap on their shares.
- (c) BA will ensure that, together with its subsidiaries and franchisees, it will not operate services which use more than 70 per cent of slots available at Gatwick in any one hour nor more than 65 per cent of slots available in any two-hour period.