Part II

Background and evidence

3 The parties and background to the merger

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Introduction

3.1. This chapter describes briefly the businesses of the parties and the existing relationship between them; and provides information about the history and financial performance of each. It ends with a description of the terms of the proposed merger and events leading up to it.

British Airways Plc

History and acquisitions

3.2. BA can trace its origins back to the first commercial international flight in 1919 from Hounslow to Le Bourget which carried one passenger, newspapers, cream and grouse. During the next two decades various airlines were formed and merged so that by 1939 there were two main airlines in the UK, Imperial Airways Ltd and British Airways Ltd. These companies were nationalized to form the British Overseas Airways Corporation (BOAC) which began operating in April 1940. In 1946 BOAC moved its operating base to Heathrow. In the same year, the Civil Aviation Act 1946 created scheduled service monopolies for state-owned carriers and formed British European Airways which was hived off from BOAC only to be reintegrated in 1974 to form BA.

3.3. Limited competition from the private sector was permitted on scheduled services from 1960; nevertheless losses, particularly by BOAC, were common. In 1970 BCal was formed through a merger of two other airlines[1] with government support to be a 'second force' airline based at Gatwick. It benefited from the limited transfer of some routes (Ghana, Nigeria, Libya and Paris Le Bourget) from the state carriers and from statutory protection from competition on its overseas routes but never developed into a powerful rival to BA.

3.4. BA's losses were accentuated in the 1970s by the oil price rises and economic recession. BA at that time was overmanned and productivity was low compared with much of the international airline industry. The intention to privatize BA was announced in 1979 as BA sought to cure its overmanning by expansion but this coincided with an industry recession. Plans were made to bring the company into profitability but it returned losses of £141 million in 1981 and £544 million in 1982 before generating a profit in 1983 since when it has remained profitable on an annual basis.

3.5. In 1983 the Government, consequent upon BCal's representations about the future structure of the industry, asked the CAA to review the implications of privatizing BA. The CAA recommended further route transfers from BA to BCal prior to the privatization and also recognized the need to maintain the competitive position of BA relative to foreign airlines. The CAA's recommendation was turned down and there were merely some route exchanges between BA and BCal.

3.6. Privatization was achieved in January 1987. In the prospectus, the Secretary of State for Transport stated: 'HM Government has no intention of promoting further route transfers such as occurred in 1984'.

3.7. Between 1982 and 1986 BCal increased its operating profits from £14 million to £61 million yet by 1985 it was experiencing significant cash outflows caused by capital expenditure. A retrenchment exercise was implemented and a number of airlines showed interest in acquiring all or part of BCal. In 1986 its operating profit was more than wiped out by passengers' reduced willingness to travel by air as a result of terrorism and by the devaluation of the Nigerian naira. In July 1987 an agreed bid by BA was announced at a price of £237 million but the bid lapsed on a reference to the MMC. The bid was renewed at a price of £246 million and was completed early in 1988.

3.8. The acquisition of BCal was cleared in the light of a number of commitments offered by BA including, *inter alia*, the relinquishing of 5,000 annual slots and several route licences. The route licences were estimated to represent nearly 20,000 of the 33,500 annual slots then used by BCal. BA told us that its subsequent reapplication for some of these routes was rejected by the CAA on grounds which led it not to reapply for others and that the actual slot loss was likely to have exceeded the 20,000 estimate. The BCal merger is also referred to in paragraph 5.143.

3.9. In December 1992 BA acquired the assets of Dan-Air's scheduled service business when that company was on the verge of liquidation. The consideration was £1 plus the assumption of £40 million debt. That acquisition was cleared by the Secretary of State without reference to the MMC. The acquisitions of BCal and Dan-Air formed the platform for BA's plan to expand from Gatwick on a cost base lower than that at Heathrow.

3.10. In 1991 BA entered into a code-sharing arrangement (see paragraph 3.26) with the new CityFlyer which was being started with two small aircraft at Gatwick.

3.11. In March 1992 BA reorganized its existing services from Manchester, Birmingham and Scotland into a new division named British Airways Regional (BAR) as distinct from its core operation (including its operations at Gatwick) which it calls BA mainline, the term we have adopted for our

[1]Caledonian Airways and British United Airways

report. BAR operates smaller aircraft than BA mainline over short-haul routes and the reorganization gave BAR a lower cost base without the London overheads.

3.12. In May 1993 Brymon, based in Plymouth and in which BA had a 40 per cent interest, became a wholly-owned subsidiary following a period of financial difficulty. Also in 1993 BA and CityFlyer agreed that whilst the code sharing had been successful, further integration would be mutually beneficial (see paragraph 3.26) and in July BA's first franchise agreement was signed between the two companies. That was quickly followed in August by a franchise agreement with Brymon which became profitable in 1995 and Brymon has since expanded its operations under local management.

3.13. BA told us that Brymon operates as an autonomous subsidiary with its own management and infrastructure; without such independence, it would be unable to contain its costs particularly when operating small turboprop aircraft the needs of which bear little resemblance to those of aircraft used by BA mainline. When Brymon was acquired by BA it had no Managing Director or Finance Director and these posts have since been filled by BA secondees. Brymon's published accounts reflect its self-contained operation: during Brymon's ownership by BA its operating results have turned from loss into profit. Its trading record is summarized at Appendix 3.1.

3.14. Outside the UK, BA's first acquisition was in March 1992 when, in partnership with a consortium of German banks, it acquired a small German airline to establish Deutsche BA (DBA). In 1998 BA bought out the banks' interest so that DBA became wholly owned. DBA operates a network of eight routes from bases at Berlin and Munich.

3.15. In September 1992 BA acquired a 49.9 per cent interest in TAT European Airlines (TAT) which operated a network consisting mainly of internal services in France. Subsequently, in August 1996, BA acquired the remaining shares in TAT and in January 1997, in conjunction with a French bank, acquired the business of Air Liberté when it became insolvent. TAT and Air Liberté are now owned by a holding company in which BA has a 76 per cent interest, are managed as a single entity and continue to operate mainly French domestic routes. Both stages in the acquisition of TAT were approved by the European Commission after a one-month inquiry, subject to certain undertakings being given by BA, and the acquisition of Air Liberté was approved without conditions.

3.16. In March 1993 BA acquired a 25 per cent interest in the Australian airline Qantas following approval by respective regulatory authorities. Code sharing and other operational agreements have since been established as described in paragraphs 3.31 to 3.37.

Operations

3.17. BA mainline operates scheduled and charter services for passengers and cargo, using aircraft ranging from the Boeing 737-200 and Airbus A319 up to Boeing 747-400. Heathrow remains BA's largest base but during the 1990s, following the acquisitions of BCal and Dan-Air and the termination of the TDRs affecting distribution of traffic between Gatwick and Heathrow (see paragraph 4.33), it has built Gatwick into a significant second base. BA, with its franchisees, now offers services to 120 destinations from Gatwick which is more than it offers from Heathrow. BA[1] operates out of a total of 15 UK airports including year-round scheduled services from Birmingham, Edinburgh, Glasgow, Manchester and Newcastle.

3.18. In June 1998 BA's newly-established subsidiary, Go, commenced operations from its base at Stansted. Go was set up specifically to compete with the no-frills lower-cost sector of the market and is separately funded and managed. As at February 1999, BA offered scheduled services (including those of Brymon but excluding those of other franchisees and of Go) to 167 destinations in 87 countries.

3.19. In 1997 BA embarked on a business efficiency programme with the target of reducing costs over a three-year period by £1 billion annually. BA's third quarter announcement for the nine months ended 31 December 1998 stated that so far it had achieved reductions of £600 million, £100 million

[1]Including Brymon but excluding other franchisees and Go (see paragraph 3.18).

ahead of target, which had been crucial in maintaining profitability against factors such as the UK economic slow-down, the Asian crisis, the strength of sterling and increased competition.

Slot portfolio

3.20. At Gatwick and Heathrow there is heavy congestion during most of the day (which is defined as 0600 to 2330 local time) caused by limited airport capacity in the London area. The movement of an aircraft in or out of an airport is known as an air transport movement (ATM) and the permission to make such a movement at a particular time on a particular date is known as a slot.[1]

3.21. Slots are allocated approximately semi-annually for the forthcoming summer or winter season by the Airport Coordinator who operates under the EC slot allocation regulation.

3.22. BA has built up its slot portfolio at Heathrow over the years: ACL told us that in the summer of 1998 BA had approximately 38 per cent of the total slots in use there including those of its subsidiaries and franchise partners[2] (see paragraph 3.36). At Gatwick it was more of a latecomer and acquired slots from the Coordinator as well as through the BCal and Dan-Air acquisitions which gave BA significant increases. Other factors causing release of capacity for BA's growth at Gatwick in the 1990s were the Gulf War, recession, failure of Air Europe and the changes to the TDRs in 1991 which allowed several airlines to move to Heathrow. For the summer of 1998 BA and its subsidiaries had 33 per cent of Gatwick's slots, a figure which rose to 49 per cent when its franchisees and associated companies were included (see Table 5.40).

3.23. At both Heathrow and Gatwick there are free daytime slots available but they are mostly in the late evening after about 8 pm when they are less attractive or impracticable for commercial use. At both airports some new slot capacity becomes available each season through improved management of airport facilities.

3.24. Slots have become valuable. In December 1997 BA exchanged slots it was using on its Heathrow–Guernsey route with slots held by Air UK Limited (now KLM uk Ltd (KLM uk)). Air UK's accounts for the year ended 31 March 1998 included under the heading 'exceptional operating income' a contribution of £15 million arising from the transfer of airport slots. A contingent liability was noted on the basis that the contribution was then subject to legal challenge by a third party.

3.25. The topic of slots and their allocation is complex and is described in detail in paragraphs 4.41 to 4.77 and 5.114 to 5.119.

Code sharing and alliances

3.26. Code sharing involves the use of a single flight designator for two or more connecting flights operated by different airlines. The objective is for the respective airlines to promote connections between their flights with an enhanced customer service including access to the airport facilities and frequent flyer programmes of the other airline(s), checked-through baggage and escorted connections if time is short. There is, however, a risk that travellers can expect to fly with one airline only to find they are flying with another for part of their journey. They may also not be offered the quickest available connection when making reservations although this defect is now being addressed within CRSs. Nevertheless, code sharing is ubiquitous within the industry although several airline operators told us that they would like to see it abolished. BA has code-sharing arrangements with ten airlines in addition to its own subsidiaries and franchisees.

3.27. BA has taken its relationship with Qantas a stage further than code sharing to what it terms a joint services agreement. Under this agreement, their respective services between Australia and

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[1]ACL defined a slot as: the scheduled time of arrival or departure available or allocated to an aircraft movement on a specific date at an airport.

[2]That is, GB Airways, Air Liberté and British Mediterranean.

Europe are operated in co-operation. Pricing, scheduling and capacity management are discussed between the airlines and there is a revenue-sharing agreement.

3.28. BA has a similar agreement with Canadian Airlines covering some routes between Canada and the UK. In June 1996 BA and American Airlines announced plans for a broad alliance that has yet to receive regulatory approval.

3.29. BA was a founder member of the **one**world Alliance (**one**world) which came into being on 1 February 1999. It includes American Airlines, Canadian Airlines, Cathay Pacific and Qantas, and will include Finnair and Iberia from the second half of 1999. Each member is required to treat another's passengers as if they were its own, extending, for example, to handling booking enquiries and ticketing problems in addition to the usual code-sharing benefits. Such arrangements are not necessarily universal and there may be exceptions between carriers on a particular route. BA's franchisees, whilst not actual members themselves, nevertheless also participate in the arrangement.

3.30. Further details of code sharing and alliances are in paragraphs 5.99 to 5.104.

Franchises

3.31. As mentioned in paragraph 3.12, BA announced its first franchise agreement, with CityFlyer, in July 1993. Both companies said that they had found that the previous code-share arrangement, whilst successful, would be improved by a more fully integrated relationship. The initiative for a franchise arrangement came from BA which had been developing its franchise strategy. The initial term was five years with a requirement to discuss renewal one year prior to the expiry date.

3.32. Franchise agreements provide benefits for the franchising airline and the franchisee. The franchisor benefits by gaining a presence on routes that it would otherwise find too costly to operate and so attracts additional passengers to carry over its network. The franchisee obtains access to a brand, buying power and facilities which it could not begin to put in place by itself as well as benefiting from feed from the franchisor. Passengers changing flights between franchisor and franchisee are effectively able to intraline[1] rather than interline (see paragraph 5.11).

3.33. In 1998 BA franchisees operated to 103 destinations, 74 of which were additional to those served by BA mainline.

3.34. Under BA's franchise agreements, the franchisee provides what is seen as the BA product but using its own equipment and staff. This includes aircraft being in BA livery, cabin crew in BA uniform, adoption of BA's on-board service levels, use of BA lounges and membership of BA's Executive Club for franchisees' passengers. The franchisee is entitled to the use of BA's intellectual property rights relating to products and is required to adhere to specified standards.

3.35. In addition to support provided under the terms of the franchise, BA provides other services such as marketing, sales outlets, ticketing, CRSs, revenue management systems and aircraft and passenger handling depending on location.

3.36. Since establishing the franchises with CityFlyer and its own subsidiary Brymon, BA has extended franchises in the UK to British Regional, British Mediterranean, GB Airways, Loganair and Maersk UK. Franchisees outside the UK are Comair in South Africa, Sun-air in Denmark and, since March 1999, Business Aviation Eindhoven BV (BASE) in Holland. Other airlines such as Air France and Lufthansa have since used the arrangement (see paragraph 5.105) which is also widely used in the USA.

3.37. Further details of the relationship between CityFlyer and BA are set out in paragraphs 3.66 to 3.69.

[1]'Intralining' refers to making a connection between two flights operated by the same airline; 'interlining' refers to connections between flights operated by different airlines.

Financial performance

3.38. Table 3.1 summarizes BA's performance. A more detailed summary of BA's balance sheets and trading results is at Appendices 3.2 and 3.3 respectively.

TABLE 3.1 **BA: financial summary**

£ million

	Years ended 31 March					*Nine months ended 31 December*	
	1994	*1995*	*1996*	*1997*	*1998*	*1998*	*1997*
Turnover	6,602	7,177	7,760	8,359	8,642	6,868	6,616
Operating profit	468	618	728	546	504	527	428
Profit after tax and minority interests	274	375	473	428	460	279	388
Dividends	(106)	(119)	(131)	(154)	(176)	(54)	(52)
Retained earnings	168	256	342	274	284	225	336
Shareholders' funds	1,730	2,090	2,494	2,958	3,321	3,565	3,383

Source: BA/Commission analysis.

3.39. The profitability of BA increased significantly during the mid-1990s peaking in 1996 before falling in 1997 and 1998 at the operating level. BA told us that trading had recently become more difficult because of several factors: increased competition from no-frills carriers; strong sterling; the Asian economic downturn and a decline in business traffic. Nevertheless, results for the third quarter (nine months ended 31 December 1998) showed turnover up by 3.8 per cent and operating profit up by 21 per cent[1] compared with the corresponding previous period which had been affected by strikes. However, the impact of non-trading items, including the absence of significant gains on fixed asset sales, increased interest payable and a yen translation loss, combined to reduce pre-tax profits by almost 40 per cent. BA's interim statement indicated that the business efficiency programme had enabled operating margins to be improved and that the full £1 billion cost reduction (referred to in paragraph 3.19) would be achieved in the following year.

3.40. So far as its Gatwick operation was concerned, BA told us that the return on assets, measured in terms of cash flow as a percentage of net assets employed,[2] was inadequate at [✂] per cent against a publicly stated minimum target of 17.3 per cent. BA's 1998 annual report shows operating cash flow as a percentage of net assets at market value at 15.7 per cent (1997: 17.7 per cent). We estimate that the loss of CityFlyer, whether in terms of franchise only or completely, would affect BA's return by about one percentage point.

The franchise contribution

3.41. BA told us that it estimated the annual contribution from CityFlyer in terms of transferring passenger ticket revenue[3] at £[✂] million for calendar year 1998, an increase of [✂] per cent over 1997. Based on BA's rule of thumb that intralining generates 150 per cent more feed than interlining, termination of the franchise but maintenance of CityFlyer's services would reduce such feed revenue by £[✂] million. BA estimated the contribution[4] from feed at [✂] per cent of revenues so the loss at that level would be £[✂] million. BA estimated the contribution loss if all of CityFlyer's services were to cease at £[✂] million but that it could recoup about £[✂] million of that by rescheduling some of its own services to include CityFlyer's best routes (as described in Appendix 6.1) thereby reducing the loss to £[✂] million. In the year ended 31 March 1998, BA's operating profit was £504 million (see Table 3.1) and its annual franchise fee income from CityFlyer for the year ended 31 March 1999 was less than £[✂] million.

[1]Including results of associated companies.
[2]Calculated at depreciated replacement cost and excluding corporate assets such as headquarters buildings.
[3]Net of selling commissions.
[4]Contribution is revenue net of selling commissions less direct costs and all other costs which would be shed by ceasing to operate a route.

CityFlyer Express Limited

History and business

3.42. CityFlyer's management was originally involved with a small airline, Connectair Ltd (Connectair), in the mid-1980s which, along with other airlines, provided feeder traffic to BCal under the brand British Caledonian Commuter. Joint flight numbers and ticketing were used but the arrangement stopped short of standardization of service and livery or monitoring of product standards by BCal. In July 1988 Connectair was sold to ILG and rebranded Air Europe Express. In 1991, ILG was put into liquidation, which caused the demise of the otherwise profitable Air Europe Express.

3.43. Air Europe Express's management continued to be convinced by the feeder concept, subject to having arrangements with a major carrier covering at least code sharing, reservations and ticketing. CityFlyer was started in May 1991 using two Shorts 360 aircraft, night freight and mail contracts and staff from the aftermath of Air Europe Express. Further funding and the commercial link with a major carrier were required before scheduled services could be operated. Route licences were also required at that time and CityFlyer obtained conditional licences to fly from Gatwick to Guernsey, Antwerp and Rotterdam. The condition was that the funding required by the business plan, £1.75 million in total, be in place which in turn required establishment of the link with a major carrier. Several airlines were approached but in the event the only carrier to show interest in providing the commercial link was BA.

3.44. CityFlyer began flying its licensed routes and soon doubled its fleet to four Shorts 360 aircraft; however, it made a loss of £0.5 million in its first year because of unforeseen competition, delays in obtaining funding, and licensing delays on one of its business plan routes. In 1992 CityFlyer broke even and took delivery of the first of four ATR42 turboprop aircraft with 48 seats for which it was the UK launch customer. Aer Lingus abandoned the Gatwick–Dublin route and CityFlyer moved in with a daily service. The demise of Dan-Air in 1992 left a void on the Gatwick–Newcastle route and CityFlyer leased in a third ATR 42 to provide a thrice-daily service. In the year ended 31 March 1993 CityFlyer booked its first profit at £144,000.

3.45. In 1993 the Düsseldorf route was started and the Dublin frequency was increased. Meanwhile, the code-sharing agreement with BA had resulted in several complaints from customers who had expected to fly BA but had found they were not. BA proposed upgrading the arrangement to a franchise which CityFlyer accepted: the agreement was signed in July 1993. Services to Leeds/Bradford were started and by the year-end the fleet comprised eight aircraft—four Shorts 360s and four ATR 42s.

3.46. In 1994 CityFlyer began a four times daily Luton–Paris service on behalf of Luton under a three-year contract and management fee. In October CityFlyer took delivery of its first ATR 72, a 66-seat aircraft for which it was UK launch customer. This was used on the Dublin route where frequency was increased to four daily in response to Ryanair starting services to Gatwick. In March 1995 the Cork route was launched and by that financial year-end CityFlyer was flying to ten destinations including the Channel Islands.

3.47. In 1995 Luton cancelled the Paris contract 18 months early. The night newspaper run to Paris was lost to the Channel Tunnel but services were started to Amsterdam and Cologne. Frequencies were increased on several existing routes.

3.48. In March 1997 services to Bremen were started and about the same time CityFlyer took delivery of its first BAe RJ100 jet aircraft which it used on the Dublin route. The second such aircraft arrived in May and was deployed on the Amsterdam route which had been profitable from the start. Also in May, the Luxembourg route was started and during the year there were further increases in capacity and frequency.

3.49. Early in 1998, the Leeds/Bradford and Antwerp routes were abandoned as unprofitable to be replaced by Zürich, which had been abandoned by BA as unprofitable compared with its services from Heathrow, and increases in frequency to Düsseldorf. Charter flights, which represent about 3 per cent of total flights, were increased both for a winter ski tour operator and on summer weekends to Mediterranean destinations. Three more RJ100 aircraft were delivered in 1998 with two more due in 1999 when a daily service to Nice is due to start in July. A sixth ATR72 is scheduled for delivery in April 1999 and an ATR42 will be returned to its lessor in July. These changes will bring the fleet total to five ATR42s, six ATR72s and seven RJ100s.

3.50. Further details of the routes currently served are contained in paragraphs 5.139 to 5.141.

3.51. CityFlyer has always based itself at Gatwick and operated out of the South Terminal. Whilst this has the advantage of being adjacent to the runway and the rail station, passengers transferring to BA have to go to the North Terminal which adds about 15 minutes to transfer times. Under the franchise agreement BA is required to use reasonable endeavours to persuade GAL to move CityFlyer to the North Terminal (subject to such persuasion being consistent with BA's own interests); BA and CityFlyer told us that so far this would have been impracticable for a variety of operational reasons, not least the lack of available pier-served stands at the North Terminal.

3.52. CityFlyer was employing 677 people in December 1998 including cabin crew, flight crew and engineers. Reservations, revenue management and ticket sales accounting are outsourced to BA: reservations are handled by BA staff in their normal line of duty as, we were told, it would be impracticable to differentiate between franchise and mainline reservation calls. BA provides dedicated staff on a confidential basis to handle CityFlyer's revenue management and ticket sales accounting.

Slot portfolio

3.53. CityFlyer told us that it had never acquired slots when cash had changed hands but had built up its allocation by applications to the Coordinator. This had often entailed accepting slots at inconvenient times and working to improve them over the years as other slots became available. Swapping of slots on an arm's length basis was a standard procedure in the industry and CityFlyer was active in this respect. CityFlyer presently has an average of 96 daily slots at Gatwick, sufficient for 48 aircraft rotations. Further details of CityFlyer's slots are given in paragraphs 5.233 to 5.249.

Capital structure

3.54. In 1991 the executive directors of CityFlyer at that time contributed £250,000 which left £1.5 million to be found from other sources in order to meet the preconditions for the grant of the required licence. Lead investor was 3i Group plc (3i), which had been a shareholder in Connectair, and three other institutions made up the balance. The investment structure was £375,000 in 'A' Ordinary shares; £615,000 in 12 per cent redeemable preference shares; and £510,000 1993/97 loan stock. Each institution subscribed for each category of capital pro rata to its share of the total investment. Table 3.2 shows the total amounts subscribed by each investor.

TABLE 3.2 **CityFlyer: amounts invested**

Institution	*£*
3i	500,000
Grosvenor Development Capital Plc (now Mercury Asset Management)	350,000
Gresham Trust plc	350,000
Baronsmead Plc (now Friends Ivory & Sime PLC)	300,000
Institutional total	1,500,000
Management	250,000
Total	1,750,000

Source: CityFlyer.

3.55. A voting split of 63.75:36.25 between institutions and management was arrived at by negotiation. The institutions' votes at 63.75 per cent attached to the 'A' class shares while the management's votes at 36.25 per cent attached to existing 'C' class shares.[1] The management also owns all of a 'B' class of share capital with no votes. The preference shares and loan stock subscribed for by the institutions have since been redeemed.

3.56. In 1997 share options were granted to the original director shareholders [
Details omitted. See note on page iv.
]; see also paragraphs 3.72 and 3.73).

3.57. Rights as between the various classes of share capital, including dividend rights, are complex and are contained in the company's Articles of Association. For the year ended 31 March 1996 and subsequent years, distribution policy has resulted in approximately 50 per cent of after-tax profits being paid out as dividend.

Financial performance

3.58. CityFlyer has been profitable since the loss in 1991, its first year of operation. Table 3.3 summarizes its profitability since 1994.

TABLE 3.3 **CityFlyer: profitability**

					£'000
			Years ended 31 March		
	1994	*1995*	*1996*	*1997*	*1998*
Turnover	25,699	33,825	49,128	65,737	89,474
Operating profit	580	790	2,519	3,659	5,783
Net interest received	52	166	311	424	580
Profit before tax	632	956	2,830	4,083	6,363
Tax	(40)	(108)	(819)	(1,260)	(1,797)
Profit after tax	592	848	2,011	2,823	4,566
Dividends	(158)	(358)	(1,013)	(1,889)	(2,426)
Retained earnings	434	490	998	934	2,140
Key ratios					
Operating profit as a percentage of turnover	2.3	2.3	5.1	5.6	6.5
Profit after interest and tax as a percentage of average shareholders' funds	59	59	106	104	105

Source: CityFlyer/Commission analysis.

3.59. The table shows consistent growth in CityFlyer's profits including its ability to sustain heavy dividend payments. Its profit margin on sales has increased significantly during the 1990s to 6.5 per cent in 1998 in a period of significant growth in the airline industry. The industry is, however, notoriously cyclical and a general reduction in yields and/or load factors which did not allow CityFlyer to reduce its costs (many of which are fixed) commensurately could have a significant impact. We estimate that if CityFlyer's turnover declined by 10 per cent without any reduction in costs, its profit would be eliminated.

3.60. CityFlyer told us that its fleet of 16 aircraft has a capital value of approximately $220 million (£134 million) which is scheduled to increase to nearer $275 million (£168 million) during June and July 1999 when two new RJ100 aircraft are due for delivery. However, all of CityFlyer's aircraft are financed off-balance sheet through operating leases which means that the balance sheet (net assets of £5.4 million—see Table 3.4) does not reflect their value or their financing. CityFlyer has therefore succeeded in obtaining the aircraft it needed without recourse to its own capital resources. The balance sheet footings are thus small in relation to its turnover: turnover is about 16 times net asset value whereas in BA's case turnover is about twice net asset value.

[1]There are 1,759 'A' class shares and 1,000 'C' class shares which produces the voting split.

3.61. The operating lease payments following delivery of the two RJ100s in 1999 will be approximately £18 million annually of which about 55 per cent is attributable to the RJ100 fleet. These aircraft, the first of which was acquired in March 1997, are on ten-year leases with an option to purchase at year five which means that lease payments represent a considerable financial commitment by CityFlyer. The ATR72s were acquired on five-year leases (with one exception) with options to extend annually thereafter; most are now on two- or three-year obligations. The ATR42s were acquired on varying lease terms and most are now on annual obligations.

3.62. CityFlyer's management has achieved the rapid expansion of a cash-generative business through a period of significant growth in the airline industry. As indicated in paragraph 3.59, CityFlyer is vulnerable to downturns in margins or business volumes. Furthermore, whilst CityFlyer had net cash of £8 million at 31 March 1998 (see Table 3.4), that is not large in the context of a turnover of £100 million.

3.63. All but two aircraft of each type are financed at floating interest rates notwithstanding that they are on operating leases. All leases are denominated in US dollars so CityFlyer is susceptible to movements both in interest rates and exchange rates. CityFlyer told us that its policies are to spread risk through maintaining a diverse portfolio of routes and to conserve cash.

3.64. Table 3.4 summarizes CityFlyer's balance sheets.

TABLE 3.4 **CityFlyer: balance sheet summaries**

£'000

	As at 31 March				
	1994	*1995*	*1996*	*1997*	*1998*
Fixed assets:					
Tangible	151	171	823	1,297	3,605
Intangible	430	356	311	273	371
Total	581	527	1,134	1,570	3,976
Current assets:					
Stock	430	1,405	1,563	1,846	5,538
Debtors	4,716	4,859	6,799	9,415	14,083
Total	5,146	6,264	8,362	11,261	19,621
Creditors due within one year	(6,200)	(8,029)	(9,847)	(17,306)	(22,638)
Net operating assets/(liabilities)	(473)	(1,238)	(351)	(4,475)	959
Net cash	1,623	3,065	3,538	10,067	8,037
Creditors less debtors due after one year	284	161	292	593	537
Provisions	(213)	(354)	(1,327)	(2,912)	(4,119)
Net assets	1,221	1,634	2,152	3,273	5,414
Shareholders' funds:					
Share capital	1,149	1,149	1,149	1,149	1,149
Revaluation reserves	-	-	-	313	273
Retained earnings	72	485	1,003	1,811	3,992
Total shareholders' funds	1,221	1,634	2,152	3,273	5,414

Source: CityFlyer.

3.65. The increase in fixed assets in 1998 primarily represented expenditure of £2.3 million on aircraft engines and the increase in stocks in 1998 was caused by an increase in aircraft spares. The increase in debtors was broadly in line with the increase in turnover. Provisions represent the anticipated future cost of aircraft and engine overhaul on the basis of hours flown, and deferred tax.

Relationship between CityFlyer and BA

3.66. The most important aspect of the relationship between CityFlyer and BA is the franchise agreement, the essential features of which are:

(a) CityFlyer operates flights licensed under the agreement using the name British Airways Express and British Airways (as do other franchisees). Whilst CityFlyer is free to operate unlicensed scheduled flights outwith the franchise, it has never done so.

(b) The decision as to whether to operate a particular service as a licensed flight rests with CityFlyer. The licensed services may be varied as CityFlyer sees fit subject to BA's consent.

(c) CityFlyer may operate charter flights within Europe without BA's further consent.

(d) Aircraft, cabin interiors, staff uniforms etc are all in BA livery.

(e) Customer service staff are trained to BA standards.

(f) Customers are given access to BA facilities such as lounges and frequent flyer programmes.

(g) Franchisee flights have BA flight designators and BA promotes and advertises CityFlyer's services alongside its own.

(h) BA provides support in the form of advice, procurement services, stationery, promotional literature etc.

(i) Where goods and services are provided by BA, it does not seek to make any profit from such supply.

(j) An annual franchise fee is payable to BA (see paragraph 3.41).

3.67. There is a change-of-control break clause entitling BA to terminate the agreement if control of the franchisee should pass to another party.

3.68. The existing CityFlyer franchise agreement was due to expire in July 1998. In June 1998, in the light of the acquisition negotiations between BA and CityFlyer, it was extended until 2 December 1999. The agreement has been further extended by a period equal to the period of time which elapses between 25 November 1998 and the earliest of the date on which the sale and purchase agreement with BA is completed or on which it becomes incapable of completion.

3.69. The close relationship established by the franchise agreement created other opportunities whereby CityFlyer could utilize BA's resources. The list of resources used is extensive and is set out more fully in Appendix 3.4. The advantage to CityFlyer of having a worldwide sales network supported by ticketing and revenue management, in particular, is clearly very substantial: CityFlyer told us that about 15 per cent of its ticket sales are in countries to which it does not fly. BA charges 1 per cent of sales by way of general sales agency fee. Many of the BA facilities used by CityFlyer would either be out of reach of a small airline altogether or add considerably to its cost base, so much so that CityFlyer told us that without the franchise agreement the business would not be viable in its present form.

The merger

Origins—divestment pressure

3.70. As explained in paragraphs 3.43 and 3.54, in 1991 the CityFlyer executive directors at the time founded the company with £250,000 of their own money in the knowledge that *(a)* they would need code share, reservations and ticketing support from a major airline to be viable, and *(b)* they would need external funding before being granted any route licences[1] to operate scheduled services. 3i, which had been an investor in Connectair, agreed to subscribe £500,000 towards the business plan

[1]At that time, any scheduled service required a route licence.

requirement of £1.5 million and the three other institutions (whose investments are outlined in paragraph 3.54 and Table 3.2) agreed subsequently.

3.71. In 1991, Air Europe had collapsed, there was recession looming, the Gulf War was not long over, and Pan Am and Dan-Air were rumoured to be in difficulty (as turned out to be the case). The timing for a new airline was not propitious so the investment was perceived by the institutions as being of high risk and requiring high rewards. They were all venture capital funds whose policy was to realize an investment within three to five years so that the funds could be recycled.

3.72. The percentage of voting shares held by the original directors and management (Founders) had been 36.25 per cent but in 1993 options (1993 options) were extended to another two individuals potentially diluting the Founders to 35.2 per cent. In 1996 CityFlyer engaged a firm of accountants specializing in corporate finance issues to assist in negotiations between the institutions and the executive directors to improve the Founders' and option holders' shares of the equity. The institutions decided that the time had come for them to realize their investments and in 1997 options were granted to the Founders increasing their potential interest to 38.95 per cent. Inclusion of the 1993 options takes the total potential management interest to 41.65 per cent.

3.73. [

Details omitted. See note on page iv.

]

3.74. [

Details omitted. See note on page iv.

]

3.75. [

Details omitted. See note on page iv.

] In 1997 a decision had been reached among all shareholders that an outright sale of 100 per cent of the capital of CityFlyer was the preferred solution and HSBC Investment Bank plc (HSBC) was appointed as adviser to handle the process.

Flotation

3.76. [

Details omitted. See note on page iv.

]

BA—the attractions to CityFlyer

3.77. CityFlyer and its advisers explained to us the attractions of BA as a buyer. Apart from CityFlyer itself, BA was the airline which was currently deriving most benefit from CityFlyer's business through its franchise agreement. Furthermore, CityFlyer was deriving significant benefit through that agreement albeit in exchange for a fee. As a business, it had been built up specifically to take maximum advantage of the BA links. A sale to BA would therefore maintain the status quo which would have significant benefits for both parties. So far as price was concerned, HSBC advised that BA might have been willing to pay a premium to protect its feed traffic. BA was therefore perceived as the natural buyer although the reality of the regulatory issues to be overcome was acknowledged. For that reason, HSBC recommended that BA's interest in buying CityFlyer should be gauged and that the strength of interest of alternative buyers should also be assessed.

3.78. On 4 March 1998 BA entered into a confidentiality undertaking with CityFlyer and was provided with further, limited information which, on 14 April 1998, resulted in a written conditional offer being made to acquire all of the CityFlyer shares for cash.

The sale and purchase agreement

3.79. The sale and purchase agreement between BA and the CityFlyer shareholders (the Agreement) was made on 25 November 1998 with completion due 12 working days following fulfilment of all conditions precedent. Such conditions included: the Secretary of State indicating, on terms satisfactory to BA, that he considered that the proposed acquisition did not create a qualifying merger situation or that it did not operate against the public interest; and/or if the merger should qualify for investigation under the merger control provisions of the Netherlands Competition Act, the Netherlands Competition Authority making a decision, in terms satisfactory to BA, that a licence under that Act was not required.

3.80. The Agreement imposes, *inter alia*, non-compete obligations on the executive director vendors for two years from the date of completion. There is also a bonus arrangement to encourage management vendors to generate profit and feed traffic to BA.

The value of CityFlyer

3.81. HSBC carried out a preliminary study in 1997 followed by production of a strategy paper. Its advice was that on an arm's length basis, CityFlyer was worth £[✂] million to £[✂] million. However, CityFlyer had a strategic position at Gatwick through its holding of 12.2 per cent of the slots which might justify a premium the amount of which could not be judged. Considerable interest in CityFlyer from within the industry was anticipated and HSBC embarked upon a market testing process to quantify that interest and to provide support for negotiations with BA.

Other potential buyers

3.82. HSBC's process of market testing early in 1998 (see also paragraphs 6.214 to 6.219) identified other potential buyers which expressed interest, notably Virgin Atlantic [

Details omitted. See note on page iv.

]. BA indicated to HSBC that whilst it was keen to negotiate an extension to the franchise agreement, it preferred the status quo and was reluctant to buy CityFlyer itself. [

Details omitted. See note on page iv.

] HSBC's file notes indicate that Virgin Atlantic expressed continuing interest but had emphasized at the outset[1] that it was not prepared to be drawn into an auction or be used as a stalking horse; [

Details omitted. See note on page iv.

]. The sale to BA was therefore pursued and a sale and purchase agreement was signed on 25 November 1998; it was referred to the Commission on 20 January 1999.

3.83. On the day of Virgin Atlantic's hearing at the Commission (1 March 1999) it dispatched a letter to CityFlyer's shareholders offering to match BA's bid of £75 million on the same terms and conditions on a sight unseen basis. At that point, CityFlyer's shareholders were contractually bound to BA subject to conditions precedent being met or (where possible) waived; they were not, therefore, able to accept any such offer. [

Details omitted. See note on page iv.

] Exchanges between CityFlyer's advisers and Virgin Atlantic followed the 1 March offer and copies of relevant letters are at Appendix 3.5.

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[1]In a meeting on 20 January 1998.

3.84. [

Details omitted. See note on page iv.

]

3.85. [

Details omitted. See note on page iv.

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