

6 Views of the main parties

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Introduction

6.1. This chapter summarizes the views of BA and CityFlyer, the main parties in the inquiry, which were presented in written submissions and at hearings. Views of CityFlyer's institutional shareholders are also included.

British Airways Plc

Origins of the transaction

6.2. BA told us that the sale was a logical development in the relationship that had existed between BA and CityFlyer for over five years and which had played a substantial role in the development of BA's network operation based at Gatwick. That operation had, in turn, been the engine behind the development of Gatwick after many years of failure.

6.3. CityFlyer had been a BA franchisee since July 1993. Although it was free to operate outside the franchise, it had chosen with minimal exceptions to operate exclusively as a franchisee. As such, it operated on routes which could only succeed on the basis of CityFlyer's lower cost structure and carriage of significant feed traffic to and from BA's network. To that end, CityFlyer and BA already co-ordinated their schedules to provide a convenient connecting service at Gatwick. The inter-dependence of the two airlines was already significant.

6.4. From CityFlyer's perspective, at least 25 per cent of its passengers connected to or from BA services and it made substantial use of BA's operational facilities. From BA's perspective, CityFlyer's feed traffic accounted for an estimated incremental revenue on its mainline routes of £[8] million in 1997/98.

6.5. The proposed sale of CityFlyer had come about at the initiative of CityFlyer's institutional shareholders. BA told us that it would have been content to extend the franchise agreement on mutually agreed terms. However, CityFlyer's institutional shareholders wished to realize their investment, consistent with the normal policy of venture capital funds. BA's preference had been to retain the status quo—a stable franchise network—but had judged that this was not realistic. BA had therefore concluded that an outright purchase was the only logical and practical step which would maintain the routes and valuable feed market developed under the franchise. The decision to purchase CityFlyer had come about not by reason of any BA strategic plan. Rather it was a reaction to changing circumstances within CityFlyer itself. The maintenance of the BA network was a matter of strategic importance and that was the motivation behind the acquisition. It was the only means by which BA could ensure that the activities of CityFlyer would be preserved and developed in accordance with existing policies.

Jurisdictional and legal issues

6.6. BA accepted that arrangements were in progress or contemplation which, if carried into effect, would result in the creation of a merger qualifying for investigation within the meaning of the FTA.

Development of Gatwick

6.7. BA told us that the relationship between BA and CityFlyer had to be seen in the context of the development of Gatwick.

6.8. BA operated out of 15 airports in the UK. Heathrow remained the largest but Gatwick had been built up into a significant second base. Over the last 15 years, several airlines had tried to establish a network based at Gatwick, most notably BCal, Air Europe and Dan-Air. During the 1980s no airline had been able to develop a viable short-haul network to support long-haul routes based at

Gatwick. Three airlines had failed and two had been rescued by BA which had, particularly over the last seven years, made a substantial commitment in money, management effort and operations, to the growth of the airport.

6.9. Over a period when other long-haul airlines had largely shunned Gatwick, BA had added frequencies and destinations. After the change in TDRs in 1991 many airlines had moved to Heathrow, depriving Gatwick of short-haul services, interline opportunities and a significant number of long-haul services. (Moreover, any agreement with the USA on open skies would reinforce this trend, because US airlines currently serving Gatwick all said that they wanted to operate at Heathrow.)

6.10. BA's investment at Gatwick had been substantial. Even over the last three years it had amounted to at least £1 billion of capital allocated there. BA's early decisions to invest in building up an efficient short-haul network and in developing franchise operations had been made at a time when yields at Gatwick did not justify the expectation that business could be improved there.

6.11. In 1990, BA had served 20 long-haul destinations non-stop from Gatwick, compared with 35 served by 22 other airlines. By summer 1998, BA served 33 destinations (an increase of 65 per cent), whereas 17 other airlines served 33 (a reduction of 6 per cent). BA and its franchisees now flew to more destinations from Gatwick than from Heathrow and BA's activities at Gatwick accounted for 22 per cent of BA's UK revenues.

6.12. BA operated its services at Gatwick as a hub-and-spoke network. The successful joint development of Gatwick operations by BA (including Brymon), CityFlyer and other franchisees (GB Airways and British Regional) had enhanced the perception of Gatwick. In the early 1990s it had been seen as a charter and leisure airport rather than a business airport and it had not been seen as a good interconnecting airport until BA had established its network. All these developments had benefited all airlines at Gatwick and had helped reduce the imbalance with Heathrow. Consumers too had benefited: Gatwick offered services to more destinations and at higher frequencies than would otherwise be the case.

6.13. In conjunction with the development of BA's activities, Gatwick had grown substantially. BA was convinced that its continued commitment to the development of the airport, evidenced by the proposed merger, would only benefit the public interest through the enhanced prosperity at Gatwick which it would foster.

The market

6.14. BA said that defining economic markets in the airline industry was always difficult. Passengers using scheduled services travelled from a wide variety of locations and for a number of different purposes. The nature and extent of competition depended very much on the exact starting and end points of the journey and its purpose. Airports tended to have natural catchment areas from which a majority of their passengers was drawn. But some passengers using airports in south-east England would travel from as far away as Bristol and Coventry and might consider air services from Bristol and Birmingham as alternatives to driving to a London airport. For long-haul passengers, a one-stop service might be more attractive than a direct flight at an inconvenient time.

6.15. BA contended that, however the market was viewed, the supply of scheduled air services to and from south-east England (London and the home counties) was not a sensible definition of an economic market. Rather, BA believed that these services competed in a wide variety of markets and the nature and form of competition varied from market to market. BA cited three main reasons for this conclusion.

6.16. First, point-to-point passengers who travelled on scheduled air services to and from London and south-east England were not in a single economic market but represented a set of destination-specific markets, for example London–New York or London–Frankfurt. Many of these passengers would be business travellers. These were distinct markets in that a small variation in price would not induce a business traveller who needed to go to New York to travel instead to Frankfurt. However, there might be some overlap between markets. For example, Cologne and Düsseldorf airports—just 36 miles apart—offered some choice to a business traveller to the Rhine-Ruhr area. That choice would

be influenced by price as well as convenience, both in terms of the airport for the passenger's final destination and of the schedule offered by competing airlines. On long-haul services, travellers might choose between several routes to reach their final destination. For example, they might fly to San Francisco direct or via Los Angeles or some other interconnecting city. BA also pointed out that on certain city-pair routes airlines faced competition from other modes of transport such as rail (for example, London–Paris and London–Newcastle).

6.17. Second, scheduled air services to and from Heathrow and Gatwick were supported by connecting traffic which did not originate in the South-East. This connecting traffic served destinations in the UK and Continental Europe which did not have a good range of international services (for example, Newcastle, Barcelona, Düsseldorf). For passengers flying to and from these locations, a transfer at a major European hub was normally an essential part of the journey. Heathrow and Gatwick were alternative transfer stops to Amsterdam, Paris and Frankfurt and BA competed with airlines based at those hubs to carry these connecting passengers. These transfer passengers were a major element in the passenger flows to and from the London airports.

6.18. Third, the catchment area of the London airports varied for those passengers starting their journeys in or around London. Different catchment areas were particularly important for business travellers, for whom convenience was a major factor influencing choice of airport and airline. BA said that there was some substitutability between the London airports, particularly for leisure traffic and also, to a lesser degree, for business traffic. It was also the case that different leisure destinations competed.

6.19. As Gatwick had developed, the overlap between its catchment area and that of other London airports—notably Heathrow and Stansted—had increased. BA therefore concluded that it was reasonable to treat services from Gatwick as competing with services from other London airports for point-to-point passengers, particularly at the margin.

CityFlyer services

6.20. BA saw CityFlyer's services as divided into two markets serving two very different types of traveller: transfer and direct.

6.21. CityFlyer's transfer passengers travelled for business or leisure to or from conurbations served by CityFlyer and transferred at Gatwick to other flights. They transferred to CityFlyer or BA flights or to those of other airlines, but most likely on to long-haul flights. Competition for these passengers was fierce and determined mainly by the competitive strengths of the long-haul operators and their networks, in terms of price and quality of service. The strongest competition came from KLM's hub at Schiphol, Lufthansa's at Frankfurt and Air France's at Paris CDG. KLM actually advertised Schiphol as the alternative London airport and Schiphol was directly served by more short-haul feeder services from the UK regions than either Heathrow or Gatwick.

6.22. CityFlyer's direct passengers on the other hand travelled between London and other locations within convenient travelling distance from Gatwick and the conurbations served by CityFlyer. In general, business passengers were more sensitive to the convenience of schedules and less price sensitive than leisure travellers. These direct passengers had a number of alternative routings, including competing direct flights from the same originating airport to the same destination airport; indirect routings from the same originating airport to the same destination airport via another hub; competing flights from the same or nearby originating airport to the same or nearby destination airport; and other modes of travel, for example high-speed rail. BA concluded that only the first (competing direct flights from same originating airport to same destination airport) was unambiguously in the same economic market as the CityFlyer services. Looked at on this basis, there would be no competition issue raised by the merger. The other options would be viable for some—though not all—passengers and would have some impact on demand faced by CityFlyer to some degree. The significance of that impact could be decided only route by route.

6.23. BA said that it was difficult to establish the economic market for these direct passengers. The direct passengers travelling on city-pair routes on which CityFlyer operated might crudely approximate to a market, given the likely unattractiveness to most short-haul passengers of indirect

routings. However, it was also important to take account of competition from other modes of travel and nearby airports.

6.24. BA said that no-frills airlines competed with CityFlyer on its Amsterdam, Dublin and Cork routes. It was possible that many conventional short-haul services could be taken over by some of these low-cost no-frills operators but it was too early to predict. Unpublished research by the Consumers' Association suggested that low-cost no-frills airlines competed for business as well as leisure passengers (81 per cent of business passengers who had flown on a low-cost carrier would do so again in the future).

Low-cost no-frills airlines

6.25. BA said that the overriding reason why it had invested in its low-cost subsidiary Go was to ensure that BA was involved in serving a completely new emerging market. This new market, which had not existed before, was demonstrated by the increase in overall passenger numbers. Asked whether the market was segmented as between customers for low-cost no-frills services and for full-service carriers, BA said that the impact of low-cost carriers on existing airlines was clear. (For example, both Lufthansa and SAS had introduced new services which appeared to be direct responses to Go's introduction of services from Stansted to Munich and Copenhagen respectively.) There must therefore be a degree of overlap in the markets being served.

6.26. The effects on BA's yields and revenues were less clear: the research was inconclusive and the market was changing fast. However, BA said that at the simplest level it was readily observable that, where there had been a noticeable loss of passengers overall, there was a consequential overall revenue loss. What was less clear, however, was the extent to which such revenue losses were attributable to loss of share across the board or were concentrated in what might be presumed to be the more 'vulnerable' segments of the market, such as price-sensitive leisure passengers.

6.27. BA submitted that the weight of evidence, taken overall, whilst perhaps not absolutely conclusive at this stage of development of low-cost carriers, pointed clearly towards the conclusion that there was at the very least a substantial overlap between the markets of low-cost and full-service airlines.

BA services

6.28. As far as BA's Heathrow routes which overlapped with CityFlyer's routes from Gatwick were concerned, BA classified these similarly to the CityFlyer routes (see paragraphs 6.20 to 6.24) except that passengers using Heathrow were drawn from its own catchment area. This overlapped, but was not identical to, Gatwick's catchment area. The catchment issue did not apply to transfer passengers, for whom most competition came from other airlines which could carry them through competing hubs in Europe (for example, Schiphol, Paris etc). In any event the real competition in this market was between the long-haul airlines and not the feeders.

6.29. BA emphasized the nature of the competition it faced on the majority of city-pair routes which it operated. The economics of the airline industry were such that on routes with limited traffic there might be only one competitor, but there was, nevertheless, strong competition for passengers. However, on the denser routes—for example, across the North Atlantic—there were many competitors. In any case airlines competed very fiercely: this was reflected in declining unit prices and the industry record of poor profitability.

6.30. BA competed actively with charter operators on leisure routes (for example, to the Caribbean and some US destinations) and, so far as the BA and CityFlyer overlap routes were concerned, to Jersey and to a lesser extent Guernsey.

The competitive environment facing BA

6.31. BA emphasized that, even with access to the CityFlyer slots, BA would still face effective competition across its network as a whole. This competition ensured that BA's commercial interest was aligned with the general consumer interest. Competition ensured that if BA did not meet the needs of consumers it would lose business and the slots it used would rapidly become unprofitable.

6.32. Deregulation was leading to increasing competition. The UK domestic market and the European market were fully deregulated. Within Europe, deregulation had spurred the growth of low-cost no-frills airlines, competing strongly with established network airlines for point-to-point traffic.

6.33. Competition to BA from domestically-based airlines in the UK was much stronger than that facing the major airlines in other European countries. High-speed rail was emerging as a significant source of competition on certain domestic and short-haul European routes.

6.34. BA contended that evidence of this strong competition could be seen in its commercial performance. BA was unable to price independently of the market. Its recent financial results, for the third quarter of the 1998/99 financial year, were the clearest evidence of this. There had been a drop in unit price (yield) of more than 11 per cent and BA had reported a loss for the first time since the Gulf War.

6.35. Like other airlines, BA had had to work hard in a competitive market place to earn a reasonable rate of return on capital. In the current market environment BA's profits were under severe pressure and were certainly not at the high level that might suggest the possession of market power.

6.36. BA told us that, according to HSBC, its profitability was at the low end of the range of European airlines, with an estimated post-tax rate of return of 5.9 per cent compared with an average of 6.7 per cent. BA's pre-tax rate of return on capital employed had averaged 9.7 per cent over the last five years. This was significantly below the current rate of return among quoted companies in the transport sector (22.5 per cent) and in other capital-intensive sectors, such as electricity and water (15.9 per cent), mining (15.9 per cent) and oil (16.8 per cent).

6.37. BA's business efficiency programme reflected the strong competitive pressure in the airline industry to reduce costs to match the downward trend in yields. In the first three quarters of the current financial year, BA's average passenger revenue per seat-kilometre fell by 5.5 per cent in cash terms compared with 1993/94. This represented a fall of around one-fifth in real terms over five years. BA was publicly committed to achieving business efficiencies worth £1 billion by the year 2000/01 and had already made a good deal of progress towards achieving this goal. There were many areas in which BA today was competitive with its European competitors despite the high exchange rate.

6.38. BA contended that the acquisition of CityFlyer would not change its competitive position, not least because CityFlyer was already an integral part of the BA network. With CityFlyer as part of the network, BA was still operating in very competitive markets and was subject to strong pressure to act in the consumer interest, through enhancing the quality of service and providing services at competitive prices. The proposed purchase of CityFlyer was therefore not against the public interest and should be allowed to proceed.

BA's plans for CityFlyer

6.39. BA told us that CityFlyer would operate as a separate subsidiary in the BA group under the present management, which would be charged with maximizing the profitability of CityFlyer's activities and its feed to the BA network. CityFlyer's low cost base would ensure that it was not merely preserved as a separate entity but was given every encouragement to grow and so help underpin the economic development of the Gatwick area.

6.40. Once it became a subsidiary of BA, CityFlyer would be run as an independent business from a legal, financial and operational perspective, in order to safeguard CityFlyer's low unit costs. It would have a separate board structure, comprising members of the current management team as

executive directors, together with an equivalent number of BA-nominated directors. The management of CityFlyer would continue to be responsible for all usual ongoing operational decisions. Like BA's other subsidiary airlines, Brymon and BAR, CityFlyer would retain its own slot management team, which was adept at managing and growing its slot portfolio to maximum advantage for CityFlyer's network.

6.41. BA told us that the acquisition had been contingent on reaching agreement to retain the key CityFlyer management in place. That agreement had now been reached. BA had offered an incentive package to the existing management, which in broad terms provided for a bonus linked to CityFlyer's performance payable over three years and split 60 per cent in relation to CityFlyer's profit and 40 per cent in relation to the level of feed passengers to BA.

6.42. CityFlyer would continue to operate under a franchise agreement with BA, on the thin short-haul routes to which it was particularly suited. BA intended that CityFlyer would continue to operate from Gatwick's South Terminal (see also paragraph 6.75) and CityFlyer staff would retain their employment. CityFlyer's revenue management function would be performed by the dedicated team currently fulfilling that function. CityFlyer would continue to have freedom of choice over sourcing products and services which were not key to the BA brand image.

6.43. BA would therefore operate CityFlyer in much the same way as it did Brymon, which had been a wholly-owned subsidiary since 1993 but was also a franchisee. Brymon had a separate board and management structure with responsibility for all day-to-day operational decisions, a separate profit and loss account and, as a franchisee, it established its own minimum rates for services. It had its own dedicated revenue management team, which actively pursued Brymon's own interests. For example, when after the acquisition Brymon had moved some of its routes from Heathrow to Gatwick, this had been at the initiative of Brymon itself, for its own operational reasons. (The routes had been moved because Brymon wished to expand its services and could not obtain the necessary slots at Heathrow.)

6.44. BA told us that under the franchise agreement its Gatwick–Zürich route had been transferred to CityFlyer in 1998 (although that transfer had not also involved the transfer of slots from BA to CityFlyer). CityFlyer had also decided to cease operating services on the London–Antwerp and London–Leeds/Bradford routes in order to provide more frequent services on other more profitable routes. Once CityFlyer became part of the BA group, certain synergy opportunities would arise (see also paragraph 6.84).

6.45. BA was currently evaluating its European network of short-haul routes. Experience with the London–Zürich route, which had been unprofitable for BA but profitable for CityFlyer to operate, confirmed that there was scope for transferring certain short-haul routes from BA mainline operations to CityFlyer, in order to benefit from its lower cost base. CityFlyer's low costs would ensure that its separate corporate status was preserved and that there might be scope for increasing the scale of its operations.

6.46. In addition, it might be efficient to operate a route with a mixture of BA and CityFlyer aircraft (with the large BA aircraft serving the peaks and the smaller CityFlyer aircraft serving the middle of the day). It would be much easier to achieve this kind of arrangement with a subsidiary than a franchisee and BA expected to take advantage of such opportunities arising after the merger.

6.47. BA said that there was further scope for optimizing the BA and CityFlyer schedules so as to maximize feed traffic. This could be achieved under the franchise agreement. But such synergies would be more readily achievable after the acquisition. BA would be in a position to co-operate fully absent the fear that, at its expense, it was simply assisting the development of a business that could terminate its relationship with BA and possibly become associated with a competitor. To the extent that such synergies were realized, they would benefit the consumer. In particular, the experience of CityFlyer on the London–Luxembourg route had demonstrated the advantages to the consumer of the expansion of CityFlyer's operations. (Before CityFlyer began its Gatwick–Luxembourg service in 1997 passenger numbers on London–Luxembourg routes had been declining. Since then, Luxair had increased its daily frequencies and passengers had increased by 24 per cent.)

6.48. So far as aircraft were concerned, BA told us that all future BA mainline services at Gatwick would be operated with the Airbus series and CityFlyer would continue to operate smaller aircraft than these.

Effects of the proposed merger

6.49. BA argued that the transaction's impact on competition must be considered in the context of strong point-to-point competition and intense competition between several large airline networks. Each network competed with others to attract passengers from other locations, particularly in Europe where traffic flows were not strong enough to sustain direct flights to a broad range of destinations.

6.50. The growth of competition in the European aviation industry had been spurred by relatively low barriers to entry. No special technologies were needed. Aircraft could readily be leased, tended to depreciate slowly and could be sold if market conditions warranted. These low entry barriers were reflected in the establishment and rapid growth of airlines such as Virgin Atlantic, British Midland, Ryanair and easyJet. Slots were a potential constraint on growth but had been readily available at Luton and Stansted and—until recently—at Gatwick. New entrant airlines also found it possible to gain slots at Heathrow.

6.51. BA told us that the increased competition had resulted in relatively low levels of profitability. As noted by the CAA,¹ real passenger yields had fallen. Analysts and commentators agreed that these historic low levels of profitability were not due to cyclical trends and saw little reason to expect change.

6.52. The industry was subject to strong competitive pressures to raise productivity, reduce average fares and respond to rising consumer demand. Two particular features of the airline industry affected the nature of competition: first, many routes would support no more than two direct operators; and second, the importance of networks.

Competition between BA and CityFlyer

6.53. BA told us that its commercial relationship with CityFlyer had developed further than envisaged in the franchise agreement and the relationship had proved highly successful for both undertakings. As a consequence of the success of the franchise, the parties had become almost indistinguishable from the perspective of customers and competitors. Indeed in its decision on the merger of KLM and Air UK, the European Commission had identified BA and CityFlyer as being the same economic undertaking in its analysis of competitive forces in the relevant market.

6.54. As a result of this close alignment, there was scope for only very limited competition between the two airlines on standards and service. CityFlyer was free to compete on price although it did so to a very limited extent. BA contended that the transaction would not operate against the public interest because the organizational structure of CityFlyer would continue largely unchanged and the enlarged group would continue to face effective competition on the routes affected.

6.55. BA pointed out that it and CityFlyer had no overlapping services on airport-pair routes, only on city pairs. All the city pairs were intra-EEA routes and fully open to competition from any EEA airline. BA stressed the importance for the analysis of separating out direct point-to-point passengers from indirect passengers. An indirect passenger (for example, travelling from Düsseldorf to New York via London) was not a purchaser in the Düsseldorf–London market. Rather, that passenger was a purchaser in the Düsseldorf–New York market for whom the routing via London was only one of many alternatives. Given the diverse options available to such customers, the merger would not adversely affect them. In practice, the real competition for these passengers was between the long-haul carriers, not the feed airlines. 39 per cent of BA's Gatwick passengers and 44 per cent of its Heathrow passengers were transferring to and from another BA flight or a flight operated by one of BA's

¹CAP 685, CAA, *The Single European Aviation Market, the First Five Years*, 1998.

franchisees. These indirect passengers—who had many alternative network routings—were therefore a significant element of the passenger flows on the city-pair routes.

6.56. BA noted that the costs of adding an extra service or frequency on these city pairs were low. It was equally possible for a carrier to add capacity by increasing the size of aircraft it used. Moreover, the sunk element in these costs was modest. And availability of slots was not an insuperable barrier to entry. In London slots were available, albeit not readily at Heathrow and Gatwick. Slots were much more readily available at Stansted, City and Luton which were all well suited to short-haul operations of the kind involved in the overlapping city pairs and more recently had offered significant and increasing competition on those routes. At the other end of those routes, slot constraints were an issue only at Düsseldorf Rhine-Ruhr airport.

6.57. BA argued that there was ample competition, both actual and potential, on city pairs where BA and CityFlyer currently overlapped. This competition was both from other operators and from other airports; and there was strong competition from rail services on the London–Newcastle route. Entry by low-cost no-frills airlines was a significant possibility. BA saw very little difference between the merger and the current situation whereby CityFlyer had voluntarily chosen not to compete with BA but to be a BA franchisee and align its services and fares. BA argued that the potential competition on city-pair routes was more of a reality than the potential for CityFlyer to use its existing independence to compete with BA, since CityFlyer depended for its viability on being part of BA's network.

6.58. Asked if it had ever refused to license CityFlyer to operate a route proposed by CityFlyer under the franchise agreement, BA said that, apart from CityFlyer's proposal to introduce a Gatwick–Isle of Man service, it believed it had never so refused. In late 1997 BA had declined to license CityFlyer under the franchise agreement to start a service to the Isle of Man, though it had indicated willingness to reconsider if circumstances changed. BA had declined because at that time it was itself contemplating a code-share arrangement on the Heathrow–Isle of Man route with Manx Airlines (the sister company of a BA franchisee, British Regional). In the event, agreement between BA and Manx Airlines was not achieved. In spring 1998 CityFlyer had notified BA that it was no longer interested in providing a Gatwick–Isle of Man service. In the absence of any renewed interest by CityFlyer in this route, BA considered it had not in reality prevented CityFlyer from introducing it.

Slots at Gatwick

6.59. BA told us that it did not intend to deploy CityFlyer's slots in an anti-competitive way and that there was no basis for concluding that it would in fact do so. BA had a straightforward business case for its acquisition of CityFlyer which stood on its own merits, involving the continued use of CityFlyer slots for short-haul feeder routes. BA was buying CityFlyer as a self-standing business and would not have paid £75 million for the slots alone. Even with access to the CityFlyer slots, BA would still face effective competition across its network as a whole.

6.60. BA told us that in September 1998 it had 30 per cent of all Gatwick slots, while CityFlyer had 12 per cent. Following the acquisition, the merged company would therefore have 42 per cent of Gatwick's slots. Under the organizational structure intended for CityFlyer, these slots would continue to be deployed by CityFlyer and BA for the purposes of their respective operations. The change in ownership would not in fact result in the release of CityFlyer's slot portfolio to BA. Nor, in light of the existing franchise, would the acquisition result in any change in the relative attractiveness of the combined operation from the point of view of the individual passenger.

6.61. The purpose of BA's acquisition was to maintain and develop its network at Gatwick, building on the advantages which CityFlyer could offer as a low-cost operator of short-haul routes. The development of a hub-and-spoke network of airline services offered benefits to consumers in the form of some combination of increased destinations, higher frequency of service and lower fares. The combination of BA and CityFlyer at Gatwick had realized these benefits, particularly in the network size and service frequency. BA's purchase of CityFlyer would permit these advantages to be preserved to the greatest extent possible despite the extremely tough trading conditions in the industry, with obvious benefits to the consumer.

6.62. BA said that it was possible that over time the pattern of demand might make it sensible to redeploy a CityFlyer slot on an alternative short- or long-haul service. If that were to happen, it would be a rational and desirable use of the slot to satisfy the requirements of the market. There was no reason to believe that any redeployment would take place for other reasons. If BA did wish to act in that way, the rational approach would be to divert slots from existing BA routes rather than from CityFlyer's more profitable operations. BA could have taken that step at any time, had it wished. Indeed, during the very substantial building up of its long-haul network at Gatwick, BA had never eliminated a service to a short-haul destination for this purpose. Furthermore, there were currently no significant business opportunities denied to BA which could be realized through access to CityFlyer slots and which would yield a better return to BA than would be achieved by maintaining CityFlyer's use of the slots. BA had assessed the likely slot position at Gatwick for the next few years and concluded that the slots required for its planned schedule development would be available, without recourse to CityFlyer's slots.

6.63. There were already constraints on anti-competitive behaviour in the use of slots which would continue to apply to BA and CityFlyer after the merger. All airlines were subject to the 'use-it-or-lose-it' rule. In addition, there were effective remedies available to counter anti-competitive behaviour in the use of slots which could swiftly correct the position. Both the CAA and the European Commission had specific powers designed for precisely that purpose and, in addition, any aggrieved airline could seek swift and effective injunctive relief from the High Court. Indeed, because of the importance of advance sales, airlines needed to give the market information on route and frequency changes significantly before introducing them to ensure their success. Moreover, given the manner in which services developed, it was typically some time before a new route or frequency had a competitive effect.

6.64. BA did not consider that its acquisition of CityFlyer would affect access to slots at London airports. This issue had also to be considered in the context of five competing airports. Slots were more readily available at Luton, City and Stansted than at Heathrow and Gatwick. However, even at Heathrow and Gatwick slots were available to some degree. At Heathrow, new slots were created by BAA and existing slots did change hands either through the pool or by private trade. At Gatwick, there was still greater scope to increase the number of slots available. BA had analysed information from ACL's database (as at 2 March 1999) of slot increases and decreases at Gatwick for the peak week beginning 6 September 1999 compared with the same week in 1998. This showed a net increase of 472 slots a week, of which 326 were between 0600 and 2059 local time. It was therefore still possible for other carriers to build up slot portfolios.

6.65. BA submitted that market conditions had changed significantly since the MMC considered the merger between BA and BCal in 1987, particularly with the development of competing hubs. In the last two to three years BA had begun to feel the strong competitive effects exercised by operators at the European hubs as well as from the services of overseas airline alliance partners operating in the UK.

6.66. BA did not accept the view that the merger should be examined in terms of its share of scheduled slots at Gatwick, since slots were fully interchangeable between scheduled and charter services.

6.67. On the question of whether slots at Gatwick could be seen as constituting an economic market, BA took the view that slot provision was so heavily regulated, with no real relationships between supply, demand or prices, as not to be recognizable as a market in the conventional sense.

6.68. On whether the merger would foreclose competition, BA said that while CityFlyer's slots would not be available for other operators, that applied equally under the current franchise arrangement; indeed it could be said of the slot portfolio built up by any airline. There had been press speculation about what alternative uses other airlines might want to make of CityFlyer's slots, but it was impossible to evaluate what the consequences might be. BA argued that the transaction should be approached on the basis that it would be in the public interest to maintain the existing extensive network. BA was not a giant airline in world terms, but a relatively medium-sized one. And its main competitors all had much larger shares of slots at their respective hubs than did BA at Heathrow and Gatwick.

Night-time operations at Gatwick

6.69. BA told us that the merger would have no effect on the degree to which BA used its allocations of night movements or QC. The overall night movements limit did not constrain operators at Gatwick, nor did the QC limit in winter. It was the QC limit at Gatwick in summer which acted as a constraint on all operators. BA's only night operations were long-haul arrivals and, as it introduced quieter aircraft, its requirement for QC would decline (see paragraph 5.265 and Table 5.45).

6.70. BA told us that after the merger CityFlyer's small number of night movements would come out of BA's allocation, so there might even be a small benefit for operators who relied on airlines like CityFlyer handing back their unneeded allocations.

6.71. BA said that the proposed new system to allocate night movements and QC (according to historic use rather than VPP) would not be affected by the merger. In any event, if the new scheme were introduced, BA would get a smaller initial share but still sufficient for its needs and CityFlyer would also get less. BA had a marginal preference for the existing scheme but did not regard it as a major issue.

6.72. BA said that late handing back of slots was a problem at all coordinated airports. At Gatwick BA handed back all the slots it knew it would not need by the deadline required under the local rules and handed back further unneeded slots as its plans were adjusted and finalized. On the use of strategic delay in the handing back of slots as a weapon against other airlines (see paragraphs 7.10 and 7.23), BA considered this to be 'slot abuse', of which BA was not guilty. Slot abuse was monitored at Gatwick by a slot performance committee and was punishable ultimately by expulsion from the airport of the airline concerned.

Facilities at Gatwick

6.73. BA told us that facilities at Gatwick were allocated to airlines by GAL according to formulae designed to be fair and to achieve maximum use of those facilities. The formulae were tested occasionally by the AOC on which airlines, including BA, had one vote each. GAL would take account of recommendations from the committee but GAL itself had the final say in decisions about facilities.

6.74. BA currently leased all three of the available hangars at Gatwick which could accommodate Boeing 747 and 777 aircraft. One of these would revert to its owner in spring 2002 and the others would be returned to GAL in the medium term when BA built its own facilities. BA told us that CityFlyer was satisfied with the current arrangement whereby it had its own hangar for small aircraft on land sublet from BA. Availability of hangar space at Gatwick would not be affected by the merger.

6.75. BA said that, in order to achieve minimum connecting times, it would like CityFlyer and BA mainline services to be in the same terminal but that this was not achievable. CityFlyer simply could not be accommodated in the North Terminal at present and there were no mechanisms whereby another airline could be forced out against its will.

Travel agents and frequent flyer programmes

6.76. BA said that CityFlyer was already a full participant in BA's frequent flyer programmes. CityFlyer did not participate in BA's loyalty schemes for travel agents and corporate customers but would do so after the merger, though CityFlyer's revenue in the UK was so small as not be material (a little over 2 per cent of BA's). With regard to the ongoing investigation by the European Commission into both schemes BA said that, while hoping for no adverse rulings, it expected that any rulings resulting from the inquiries would apply to all its business, not just to the business before the merger.

Employment

6.77. BA told us that over 40,000 jobs depended directly or indirectly on Gatwick and many of these were directly or indirectly attributable to BA's investment there.

6.78. BA's Chief Executive had said publicly at the time the merger was announced that no job losses would result from its purchase of CityFlyer. BA subsequently told us that the transaction was contingent on retaining key CityFlyer management—see also paragraph 6.41.

6.79. BA understood that CityFlyer's workforce at all levels favoured the acquisition by BA. The growth of and investment in Gatwick over the last decade was the strongest evidence of the benefits that were achievable through the co-ordinated operation of the two companies. Prohibition of the merger, or indeed any significant divestment of BA and CityFlyer's combined slot portfolio at Gatwick, would have serious employment consequences.

Benefits of the proposed merger

6.80. BA argued that the transaction would secure the continuation of the benefits that had already flowed from the franchise agreement between BA and CityFlyer. Those benefits worked to the advantage of consumers in the UK and more generally to the economy of London and the South-East. BA's relationship with CityFlyer had been an important part of the network that had enabled a broader diversity of services to be provided that would not otherwise have been viable.

6.81. Connecting passengers from CityFlyer's services to BA's mainline services provided a significant contribution to the overall feed that enabled BA to maintain its network at Gatwick. In turn that feed, coupled with CityFlyer's lower cost base, had maintained the viability of CityFlyer's services.

6.82. Without a mutually supportive interconnection of that kind, the network would inevitably contract. Moreover experience had shown that, to achieve an effective interconnection of that kind, mere interlining was insufficient: it needed the closer integration that was produced by the collaboration that a franchise agreement—or ownership—could provide. It was two and a half times more likely that passengers would intraline than interline.

6.83. The demand to use Heathrow, from airlines and passengers alike, imposed significant burdens upon the infrastructure both at Heathrow and in the surrounding area. The demand to travel to Heathrow in order to secure the most favourable service added to the volume of traffic and imposed clear burdens on the transport infrastructure around Heathrow. The success of Gatwick, to which BA had so substantially contributed, relieved some of that burden.

6.84. BA also told us that the better opportunities for BA and CityFlyer to exploit scheduling synergies at Gatwick after the merger would be likely to produce improved results of £[~~8~~] million a year by 2001.

Other possible outcomes in the absence of the merger

6.85. BA told us that, during the negotiations, CityFlyer had indicated that it had had discussions with other potential purchasers, although BA did not know whether CityFlyer had received any offers (other than the very recent publicized offer from Virgin Atlantic on 1 March 1999).

6.86. In light of the desire of CityFlyer's investors to maximize the return on their investment, it had appeared to BA that there was no guarantee that any other purchaser would continue to operate CityFlyer as a BA franchisee. Any purchase on a basis that terminated the franchise but maintained the CityFlyer operation more or less intact would have to be made by an airline with its own established brand. However, all other major brand airlines had chosen to focus their activities on Heathrow. Consequently they did not have sufficient presence at Gatwick to supply the level of feed traffic which had been critical to CityFlyer's success on the marginal routes on which it operated.

6.87. On the possibility of an independent short-haul operator offering interlining with BA and its competitors at Gatwick, BA took the view that if all that was available at Gatwick was an interlining short-haul network on CityFlyer's current and potential route portfolio, that operation would be at a material competitive disadvantage against all its competitors, who would be the major hub operators in Europe.

6.88. Unlike Heathrow where it had been possible for BA and British Midland to offer competing short-haul services, Gatwick was simply too small to sustain two major competing short-haul operations. BA saw the likelihood of an independent, independently-owned interlining business at Gatwick in the foreseeable future as very low. The greater likelihood was that CityFlyer would be acquired by another airline, probably a competitor to BA (for example, one of the major European airlines). It was most unlikely that two direct competitors would see it in their interests to enter into a code-sharing arrangement. Therefore the opportunity for CityFlyer to be integrated in BA's system would fall away. This would be a very serious blow to BA and to the ability of the UK to have a competing airport system which effectively competed against very aggressive and successful airlines in north-west Europe.

6.89. Asked about non-airline investors who might buy CityFlyer in the absence of the merger (a potential 'white knight'), BA said it was possible that a non-airline investor might emerge who would continue the BA franchise. Alternatively BA might itself participate in bringing about a transaction. However, BA's overwhelming preference was to proceed with the acquisition.

6.90. If the merger were prohibited, BA would have to reconsider its strategy for Gatwick. Having effectively been capped at 38 per cent of slots at Heathrow BA would, if prohibited from acquiring CityFlyer, have less than 30 per cent of the slots at Gatwick and effectively be prevented from developing in the UK. This would be very damaging to the public interest, given the highly competitive nature of the airline industry: it was in the public interest to have a successful UK-based major network airline.

6.91. Asked how it would respond to the loss of the CityFlyer routes from its network, BA said that one choice would be simply to wind down its whole investment at Gatwick and concentrate on a smaller number of competitive routes, thereby reducing competition and choice. BA provided an example of a potential BA response to the removal of CityFlyer from its network, which is set out in Appendix 6.1. BA's response to our request to quantify the impact on BA if the merger did not go ahead is in paragraph 3.41.

Virgin Atlantic's proposals for CityFlyer

6.92. We asked BA to comment specifically on Virgin Atlantic's plans for CityFlyer as given in evidence to the Commission (see paragraphs 7.84 to 7.88). BA said that this did not appear to be a fully developed business proposal and it was therefore difficult to comment on its likely competitive impact. In BA's view an undertaking to ensure CityFlyer's ongoing commercial viability was inconsistent with an intention to launch two or three new long-haul services a year, which would mean diverting 4 to 6 per cent of CityFlyer's slots each year. (Only about 20 per cent of CityFlyer's slots would be suitable for long-haul services.) BA calculated that at this rate CityFlyer's commercial schedule would be almost destroyed after about four years: some leisure routes might survive but the low utilization of aircraft would soon make these uneconomic.

6.93. Without more information it was impossible for BA to judge the possible competitive impact of any new services which might be introduced using CityFlyer's slots. By way of illustration, BA noted that Virgin Atlantic's three 'new routes' at Heathrow in summer 1999 included adding a twenty-ninth daily London–New York service and a fifth airline on the London–Chicago route. The addition of such a minimal level of competition at the expense of a short-haul route at Gatwick would not have been in the public interest.

6.94. BA acknowledged that it could interline with a Virgin Atlantic-owned CityFlyer. However, interlining would attract fewer passengers than intralining. Moreover it seemed likely that Virgin Atlantic would retime CityFlyer's services and so connections would be poor or lost completely. The great dividend of intralining was a properly coordinated schedule with minimal connection times. BA

said it was almost inconceivable that BA would wish to code share with Virgin Atlantic. First, there was the brand identity issue, which would cause confusion among consumers. Second, Virgin Atlantic had a strong commercial relationship with Continental which was allied with KLM, BA's major hub competitor.

Remedies

6.95. On the hypothetical basis that the proposed merger was held to be against the public interest, we put to BA a number of possible remedies short of prohibition.

6.96. BA regarded a requirement to divest all the CityFlyer slots as very little different from prohibition. A requirement to divest some proportion of CityFlyer's slots would reduce the valuation of CityFlyer's business and might affect BA's willingness to proceed on the agreed terms. BA subsequently told us following the judgment in *R v ACL ex p Guernsey Transport Board* that, if required to divest slots on particular routes, it would expect to dispose of them for their value. It saw no reason why slots could not be sold with an enforceable condition that they be used for a particular purpose.

6.97. On a requirement to ring-fence CityFlyer's slots, BA said that it intended to give CityFlyer's management a high degree of autonomy in the management and use of its slots. It would be prepared to consider undertakings which were not indefinite and which aligned with its commercial plans for CityFlyer, for example a restriction for a small number of years that CityFlyer's slots could be used only for short-haul (for example, intra-EEA) services. As to how an undertaking by BA not to influence CityFlyer's management of slots could be enforced, BA said that it would essentially be a matter of trust but it would not be in BA's interest to flout any undertaking that it had given. BA would be open to inquiry by the appropriate authorities and would produce documents for inspection as necessary.

6.98. BA considered that a remedy which prevented CityFlyer exchanging slots with BA after the merger would deny CityFlyer the flexibility all airlines needed to engage in mutually beneficial exchanges. This would damage the CityFlyer business. BA would be prepared to undertake to maintain the total value of CityFlyer's slot portfolio at or above its current value, based on a mutually agreed matrix of relative slot values.

6.99. BA said that a cap on the total slots that could be held by BA and its subsidiaries at Gatwick (for example, 45 per cent of total slots) would disadvantage BA as against its global competitors, many of whom had much larger shares of slots at their respective hubs. BA subsequently told us that it could contemplate an overall cap, expressed as a percentage of the available (as distinct from allocated) scheduled and charter slots at Gatwick, to which BA and its subsidiaries would be limited. A percentage cap, rather than a cap expressed as an absolute number, would still allow BA to share in any benefits from more efficient use of the single runway. This was an important consideration for BA: a cap involving an element of divestment would be a damaging limitation on its ability to develop. Its operations at Gatwick were only just moving towards profit. Return on capital was well below the published target for BA as a whole and BA should be allowed to recover its investment.

6.100. We put to BA that the European Commission had proposed,¹ as a condition for allowing BA to proceed with its proposed alliance with AA, that BA and AA should reduce their flights and associated slot holdings on certain routes so that competitors collectively could build up services occupying 55 per cent of the frequencies on these routes. In proposing this solution, the European Commission had 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 suggested a remedy in the current case of 45 per cent of slots at Gatwick. BA said that the limit of 45 per cent was related to specific routes and not to the overall level of operations at any one airport. Furthermore, the choice of a limit of 45 per cent reflected the assessment that the merging parties held strong market positions at both ends of the routes in question.

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

6.101. BA said that the case most relevant to any remedy involving capping or divestment of slots was Air France/Sabena.¹ In that case the European Commission had accepted a ceiling on the slots held by Air France and Sabena at Brussels-Zaventum airport of 65 per cent in any two-hour period and up to 75 per cent in a single hour for a period of ten years. This implied that the European Commission accepted a peak structure as a natural function of an airline's wave of activities at a hub; that such a structure would not lead to anti-competitive effects; and that the remaining slots (35 and 25 per cent respectively) would provide adequate scope for competition. BA would if necessary be prepared to accept an undertaking based on this case, though a ten-year condition would be unduly long.

6.102. In discussing a possible cap, BA pointed out that it could not legally control those of its franchisees which were not BA subsidiaries and could not therefore be answerable for their slot holdings (though BA could decline to license franchisees for particular routes).

6.103. BA said that regulatory authorities which had previously imposed caps of this kind had done so for limited periods (for example, three to four years). BA could contemplate a cap in the range of 50 to 45 per cent but the lower the cap was set, the shorter should be the period it lasted.

6.104. BA did not accept that remedies were necessary in respect of the allocation of night movements, QC or airport facilities at Gatwick. These would in any event be difficult to devise and put into effect.

6.105. We asked BA to consider the implications of these hypothetical remedies for routes currently served by BA and CityFlyer and in particular for CityFlyer's current services to UK and Channel Islands destinations.

BA's proposal

6.106. In the light of discussions at hearings (summarized in paragraphs 6.95 to 6.105) at a late stage in our inquiry BA made a proposal to us for a workable regime to be imposed by way of condition, consisting of undertakings. BA prefaced this by repeating its concern that many of the significant benefits of the current operation (international competitiveness, network feed, etc) would be lost if the Commission recommended intervention and the imposition of significantly restrictive conditions. BA believed that the evidence it had submitted should lead to the conclusion that no conditions were necessary. BA also emphasized that it was extremely anxious at the prospect of any caps on its holdings of slots being set at levels which did not permit even modest expansion.

6.107. BA would be prepared to make undertakings for a period of three to five years that:

- (a) CityFlyer would remain a short-haul operator, with short-haul being defined by reference to the IATA/CAA definition of Europe;
- (b) CityFlyer would continue to use at least the same number of slots as it currently had;
- (c) BA would retain services to the destinations in the UK and Channel Islands currently served by CityFlyer, together with a requirement to divest slots in the event that any of the specified services were withdrawn;
- (d) the slot holding at Gatwick of BA and its subsidiaries to be limited to 65 per cent of the available slots within any two-hour period, combined with a limit of 75 per cent of the slots within any single hour; and, if necessary
- (e) the slot holding at Gatwick of BA and its subsidiaries to be limited to 45 per cent of the available slots in the peak summer week, together with a requirement that to the extent that in

¹Official Journal No C272, 21/10/92 P.0000: *Commission Decision of 5.10.1992 declaring a concentration to be compatible with the common market (Case No IV/M.157—Air France/Sabena) according to Council Regulation (EEC) No 4064/89.*

the same period the franchisees used more than 5 per cent (measured as above) of the slots at Gatwick for BA-branded operations, then BA's own cap would be reduced to the same extent.

CityFlyer Express Limited

Origins of the transaction

6.108. CityFlyer told us that it had thrived in the deregulated market of the 1990s by delivering a quality product at realistic prices while maintaining a low cost base; as such, it had attracted ever increasing numbers of customers. It had provided increasing levels of employment, both among its own staff and via numerous contractors.

6.109. CityFlyer had made a significant contribution to transforming Gatwick, once an airline graveyard, into a scheduled service airport capable of providing real competition to Heathrow and other European hubs, thus increasing consumer choice. It was now outgrowing its venture capital ownership and sought a change of shareholding structure which would allow it to continue its development and thus continue to provide real benefits for the travelling public.

6.110. A code-sharing agreement with BA in 1991—which led into the franchise agreement in 1993—and the franchise itself had been indispensable in enabling CityFlyer to enter the market in 1991 and to develop its business during the past decade. 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 services and the 'halo effect' of using BA's brand. BA had also derived significant benefit from the franchise: in particular in incremental revenues from interlining.

6.111. [

Details omitted. See note on page iv.

] It had become clear that the institutional shareholders were of the view that the time was right for them to exit the business. [

Details omitted. See note on page iv.

] It was the business of the venture capitalist to realize capital gain from successful investments, usually in a period of five years, for the purpose of redeploying those funds in the market for new entrants.

6.112. 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 and might have been unwilling to pay a price which fully reflected CityFlyer's perceived strategic value. It was recommended that competition among potential purchasers for CityFlyer should be used to maximize the price and potentially to persuade BA to take the regulatory risk.

6.113. While 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's 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 require substantial additional funding to survive. They were also of the view that, even with additional funding, the company could not operate profitably in its present form without the BA franchise agreement.

6.114. CityFlyer told us that a capital structure so dominated by a group of venture capitalists did not provide a secure base for the development and expansion of an airline such as CityFlyer, which

was still a very young company. Several external factors had been extremely helpful in securing a favourable cost to revenue ratio and opportunities to seize market share. These were the economics of the airline industry, including overcapacity in the production of regional aircraft which enabled CityFlyer to acquire aircraft on advantageous terms (for example cheap flexible leases, product support etc); and the collapse of certain competitors. But when there was a downturn in the airline industry, even if not of Gulf War dimensions, the smaller companies had to fight harder to survive. If because of the economic situation profits were turned into losses which could not be supported, the slots would be useless. Thus there were mutual advantages to CityFlyer, BA and the existing and future passengers of both airlines to secure the future of CityFlyer at exactly the same time as the original financiers withdrew.

6.115. CityFlyer told us that BA had never had any ownership interest in the company, nor had it previously expressed any interest in buying it. After initial hesitation BA had made an offer of £75 million, on 14 April 1998. Virgin Atlantic [] expressed an interest in acquiring CityFlyer []. For a number of reasons (see paragraph 3.82), [*Details omitted. See note on page iv.*] the shareholders decided that they should proceed with the sale to BA. (Views of CityFlyer's institutional shareholders are set out separately in paragraphs 6.214 to 6.222.)

6.116. CityFlyer told us that the proposed merger with BA was a natural development. Under the franchise agreement, CityFlyer had adopted BA's corporate identity for its aircraft, cabin crew and ground crew. It used the same catering equipment, ground service and in-flight service. The airlines' frequent flyer programmes were combined and CityFlyer used BA's computer reservation, ticketing and revenue accounting systems. Indeed, so much had the identity of CityFlyer already merged into that of BA that the European Commission had concluded in the case of the merger of KLM and Air UK that BA's share of the London-Amsterdam route should include CityFlyer's.

6.117. CityFlyer told us that there were a number of theoretical routes for its future development, including continuation of the BA franchise; operation as a franchisee of another airline; independent development under its own brand; independent development as a lower-cost brand; sale to a mainstream carrier; and multiple code-share arrangements.

6.118. However, CityFlyer believed that in practice none of these would meet the shareholders' objectives and that to remain as a BA franchisee was the only financially viable alternative other than a trade sale. The major obstacles would remain CityFlyer's very nature as a BA franchisee, the interdependence of the businesses and the practical constraints of pursuing a strategy other than as a BA franchisee. The business had been developed by its management to provide complementary regional feed services to BA's services. A sale to any other party would not secure its development on this basis and would be likely to result in a break-up of the business with ramifications for management and employees.

Jurisdictional and legal issues

6.119. CityFlyer had no comment on whether arrangements were in progress or contemplation which, if carried into effect, would result in the creation of a merger qualifying for investigation within the meaning of the FTA.

The market

6.120. CityFlyer told us that its business was the supply of regional scheduled services from Gatwick to European destinations working hand in hand with BA to feed BA's hub, and that this formed part of an international industry engaged in the larger market as defined in the reference to the Commission: scheduled air services to and from south-east England. Despite its record of growth from 1991 to 1999, it was still a small operation based on only one of the five major airports in the reference area (Gatwick, Heathrow, City, Luton and Stansted) and holding less than 3 per cent of the total slots available at these airports.

6.121. CityFlyer emphasized that if markets were to be defined by reference to the test of reasonable substitutability, there were many markets in which suppliers of scheduled air services competed. Their performance was significantly affected by political and economic circumstances occurring outside the markets which they served.

6.122. The following factors led to the conclusion that CityFlyer, as an aligned BA operator, was subject to effective competition in the conduct of its business: the evidence on market entry and exit; changing market shares; increased choice of price, airline and airport; competition from other forms of transport; and above all the processes of liberalization. Neither on its own nor under BA ownership would CityFlyer escape those competitive conditions. However the economic market was defined, the consequences of the merger would remain the same.

6.123. CityFlyer was concerned that market definition should not conceal the interrelationships between all those factors which contributed to passengers' exercise of choice. For example, scheduled air services to and from south-east England appeared to cover a huge market yet excluded services to European destinations from airports in the Midlands, the North of England and Scotland. CityFlyer's business was affected by that commercial activity, taking away traffic that would otherwise use Gatwick. The geographic market in which CityFlyer competed was therefore not limited to that served from Gatwick or the South-East. It was also plain that CityFlyer's business on routes such as Gatwick–Newcastle and its former route Gatwick–Antwerp were affected by the introduction of faster and more frequent rail services. If price and frequency of service were regarded as tests of reasonable substitutability, then rail services could not be ignored in defining the relevant market.

6.124. Scheduled air services to and from south-east England collectively formed an economic market in certain sectors, but more significantly each city pair formed its own economic market (ie London airport system to and from an individual destination which may have a single airport or, like London, a system of airports). So far as point-to-point business passengers were concerned, these were relatively time sensitive but would see other London airports as reasonable substitutes. BA's subsidiary Go claimed that 25 per cent of its passengers were business travellers.

6.125. In the leisure market air services collectively formed an economic market by offering consumers a choice of products, destinations and prices. CityFlyer told us that the leisure market had two elements. The first element consisted of passengers who had chosen their destination (to visit a friend, relative, holiday home, home town, etc) and knew how much it would cost them when they arrived. For these passengers the question was how they could travel to that destination cheaply and in an acceptable manner. The second element consisted of passengers (but only a small minority of CityFlyer's leisure passengers) who would initially choose to travel by air, then consider how much to spend, and then see where they could go. In this respect all air services from south-east England represented the spectrum of products from which the leisure market would make a purchase and there was strong competition between the south-east airports for travellers in the leisure market. The leisure market represented a relatively smaller part of CityFlyer's business in terms of revenue but the majority of its business in terms of numbers carried. CityFlyer told us that in 1998/99 60 per cent of its total passengers were leisure travellers. There was virtually no competition from charter operators on CityFlyer's existing network of routes.

6.126. The extent to which each airport system formed an economic market was determined by the level of accessibility to each of the airports within the common catchment area of the system, and the competitiveness, particularly price competitiveness, of each airline's products competing in the specific city pair. For example, in the London–Düsseldorf market each of the five London airports offered services, as did both airports in the Düsseldorf airport system. The consumer had a choice of six carriers, five London airports and two Düsseldorf airports.

6.127. CityFlyer did not accept that each London airport had distinct catchment areas. CityFlyer pointed out that for passengers travelling from central London, the five airports were particularly substitutable for each other (but that substitutability still existed for non-central London passengers) and that the same applied for passengers arriving at one of the five airports for the purpose of travelling onwards to central London in that the five airports were readily substitutable in this case. Passengers would move between airports based on all sorts of factors.

6.128. However, there was some asymmetry between Heathrow and Gatwick in that Heathrow was for many passengers the airport of first choice. Fares that were lower by 5 or 10 per cent might persuade passengers, particularly leisure travellers, to use a competing airport but other factors would bear on their choice, for example any restrictions or other conditions applied to the ticket.

6.129. CityFlyer submitted that it was not sensible to limit the economic market so narrowly that it barely covered more than identical city pairs: that would ignore competition as between airports and networks, the dynamic process so increasingly evident in the London airports market over the past decade. The process of liberalization and the breaking down of barriers to entry meant that it was possible to look at the London airports as a unit—the test of reasonable substitutability applying to business and leisure travel.

6.130. CityFlyer argued that there were four matters of real significance in examining conditions of competition within the market for the supply of scheduled services to and from south-east England.

6.131. The first was that the five London airports did compete with each other and enabled airlines which chose one or more as their home bases to have real opportunities of competing domestically and internationally.

6.132. The second was that regional airlines having only a Gatwick base, such as CityFlyer, had taken market share from airlines using other bases within south-east England and vice versa. The entry by low-fare scheduled airlines (Ryanair, easyJet, Debonair) and the consolidation of KLM and Air UK had all significantly increased choice to the benefit of passengers and increased effective competition to CityFlyer and BA, leading the latter to respond by creating its own low-fare scheduled subsidiary airline Go.

6.133. The third was that the conditions of competition which currently prevailed were not fixed. The profitability of different routes and frequencies, the emergence of severe price competition among airlines, and the readiness of passengers to switch on grounds of value for money all made the markets volatile from one period to the next, re-emphasizing the risky and cyclical nature of airline operations. Moreover the Channel Tunnel rail link had added a major new choice for passengers, significantly affecting the use of airlines for travel to Paris, Brussels and beyond. CityFlyer's own ability to contribute further to the development of more and better scheduled services in these new conditions of competition would be secured by the merger.

6.134. The fourth was that CityFlyer's services were elements of the global air travel market in that 25 to 30 per cent of its passengers were using Gatwick as a transfer point. In this respect CityFlyer's services competed against those of all the major European airlines and their alliance partners. For example, a passenger travelling from Bremen to New York using a single airline alliance network would have the following options:

| <i>Hub</i> | <i>Carrier</i> | <i>Network</i> |
|------------|--|---------------------|
| London | CityFlyer/BA | oneworld Alliance |
| Frankfurt | Lufthansa | Star Alliance |
| Munich | Lufthansa | Star Alliance |
| Amsterdam | Eurowings/KLM | KLM Alliance Group |
| Brussels | Ostfriesische Lufttransport/ Sabena | Qualiflyer Alliance |
| Zürich | Crossair/Swissair | Qualiflyer Alliance |

6.135. This wide choice of alliance networks and hub options was common to the majority of destinations served by CityFlyer. In the major European cities on the CityFlyer network the choice between competing networks was much greater than the Bremen example. CityFlyer therefore contended that when comparing market share information for south-east England markets, it was important to recognize that the shares for carriers operating to Heathrow and Gatwick included significantly higher proportions of transfer traffic which was not point-to-point than for carriers operating to Luton, Stansted or City. Therefore the competition provided between Heathrow and Gatwick and the non-hub south-east airports was greater than market share statistics suggested.

6.136. CityFlyer told us that some leisure passengers were prepared, in order to get the right fare, to transfer between Heathrow and Gatwick.

6.137. CityFlyer submitted that London–Luxembourg was a particularly good example of how it had entered a market and stimulated competition to the benefit of the travelling public. Before CityFlyer’s entry in 1997, this route had been stagnant in comparison with similar European city pairs. Neither BA nor Luxair had significantly changed their capacities for some years and CityFlyer had calculated that new competition should stimulate growth. This had indeed been the result. Almost immediately Luxair had introduced a new service from Stansted which meant that it was possible for the first time to make a day trip from Luxembourg to London and back on a single carrier using a single London airport. Immediately the market started to grow and was still doing so. Changes in market share as between airports were directly attributable to the supply of broadly substitutable services to the London airports.¹

Competitive changes in the London market

6.138. CityFlyer told us that the vast majority of the city pairs in which CityFlyer operated had been influenced to a greater or lesser extent by the arrival of services at the ‘new’ London airports. In the deregulated market in which CityFlyer operated, competitors had complete freedom of entry and exit so far as routes were concerned. On the relevant routes there had been market entry, and indeed exit, by new operators over the last five years, with growth particularly concentrated at Stansted, Luton and City. These had previously been viewed as peripheral airports to Heathrow and Gatwick but were now making a significant impact.

6.139. Whereas Stansted and Luton previously offered low frequencies of service to major destinations and relied on relatively localized catchment areas to sustain these services, many routes were now served by three or more daily jet services. Extensive promotion in the City of London of services from both these airports suggested that airlines were targeting the larger central London market with their services to Stansted and Luton. The rapid growth in passenger numbers from the airports supported this theory.

6.140. The new services established at these airports had eroded the boundaries of traditional catchment areas for Heathrow and Gatwick and thus diminished their importance in the overall London airport system. Much of the growth had been through the introduction of new schedules by the new low-fare carriers concentrated on routes to primary cities such as Edinburgh, Glasgow, Milan, Rome, Barcelona, Dublin, Brussels, Amsterdam, Zürich and the Scandinavian capitals. CityFlyer argued that the reasons for this growth and its sustainability included:

- (a) low costs of operation at Stansted and Luton, allowing airlines to minimize overheads and offer lower fares;
- (b) lower fares encouraging substantial growth in the passenger market through increases in discretionary travel, ie existing passengers travelling more often and new passengers being attracted to markets on the basis of low fares; and
- (c) improved surface access to Luton and Stansted.

6.141. Most recently, a number of foreign carriers including Lufthansa, SAS and Swissair had launched services to Stansted. CityFlyer believed that these moves were a competitive response to the arrival of low-fare carriers on routes to these airlines’ home countries. Growth at City had been different to that at Luton and Stansted, primarily in expanding services to key business destinations like Dublin, Zürich, Edinburgh, Glasgow, Manchester, Amsterdam and Milan. New carriers at City included KLM uk, Alitalia and Braathens and schedules were mainly centred around morning and evening services to attract business travellers.

6.142. On the basis of information available to it, CityFlyer believed that this growth was largely sustainable. easyJet had recently announced profits of £2.3 million for the year ended 30 September 1998 and had up to 40 new aircraft on order for delivery to expand its operations. Trading results

¹CityFlyer subsequently noted that since details of market shares up to the end of October 1998 had been provided, a new combined service by Luxair and the Brussels-based airline VLM had started on the City–Luxembourg route, further increasing competition. For this reason it would be wholly wrong not to include Stansted, Luton and City for the purpose of assessing market shares and market power.

from Ryanair consistently reflected one of the highest profit margins of any airline in Europe: it reported £37.1 million pre-tax profit in the year to March 1998 on a turnover of £183 million. It was expected to base some of its new aircraft at Stansted from summer 1999 to expand its European route network. Ryanair had forecast that its turnover would double by 2001 and its profits would increase to £67 million.

6.143. CityFlyer predicted that the effects on the Gatwick and Heathrow catchment areas would become increasingly pronounced. CityFlyer faced competition on 10 of its 12 routes from operators at Luton, Stansted and City. Data maintained by CityFlyer indicated that the share of the market held by operators at Heathrow and Gatwick had declined from 92 to 78 per cent between 1995 and 1998 in the face of increased competition and new services from Stansted, Luton and City airports. CityFlyer believed that this was partly due to the loss of passengers from marginal catchment areas (towns like Dartford, Maidstone and Reading, lying between two airports) to the new operations.

6.144. The financial and market share results achieved by easyJet and Ryanair at airports like Stansted and Luton indicated that availability of slots at Gatwick and Heathrow certainly was not a prerequisite to mounting effective competition in south-east England. As a competitor, CityFlyer fully expected these airlines to replicate their operating formulae on more short-haul routes in future and more recent new entrants such as Debonair, Virgin Express and Go to continue expansion.

Fares

6.145. CityFlyer told us that it managed its fare levels and the availability of different fare types to maximize revenue-earning opportunities. CityFlyer's tight control of costs enabled it to offer a wide range of fares targeted at the different elements in each market it served. In order to increase the range of fares and value for money that these represented, CityFlyer offered a choice of business and economy class on most of its services.

6.146. Two classes on short-haul flights were necessary to meet the expectations of passengers paying business fares at the higher end of CityFlyer's tariff, without incurring the same costs in carrying passengers paying the fares at the lower end of the tariff. To put this into perspective, CityFlyer told us that the current average yield per passenger across the network was £[] in its Club Europe cabins and £[] in its Eurotraveller cabins.

6.147. CityFlyer told us that the needs of the business traveller differed in most cases from those of the leisure traveller. The primary difference was that business travellers needed flexibility to arrange travel at the last minute, and to be able to change travel plans in accordance with changing business schedules. The fares targeted by CityFlyer at the business market were its highest and allowed a great degree of flexibility, including the ability to change reservations to alternative airlines and to cancel travel altogether without incurring penalties. It offered fares in both cabins with differing degrees of flexibility to try to meet the needs of the 'must go' market as well as the more cost-conscious business travellers who looked to maximize value for money (for example, those whose employers as a matter of policy did not permit business class travel).

6.148. CityFlyer said that by providing two cabins it was able to segregate the passengers paying higher fares and provide them with a higher level of on-board service. In the case of jet services, they also provided wider seats. Higher fares also attracted benefits including frequent flyer awards and access to airport lounges. CityFlyer also offered slightly lower, but still flexible, fares which carried some restrictions (for example, available for use only on CityFlyer services).

6.149. CityFlyer told us that the leisure market encompassed a huge number of different types of traveller, extremes being those who made arrangements a long time in advance and those who decided at the last minute to travel and looked to see where they could go for the best price. Other types included those who booked inclusive tours with a tour operator which would choose the flights; those who travelled using frequent flyer awards; those travelling in groups; prize winners; etc. Where passengers booked flights at a published fare, price was almost without exception a deciding factor in choice of carrier.

6.150. CityFlyer offered different fares for all of these different categories of travel. It was flexible and varied its fares in accordance with competition and advance sales performance.

6.151. CityFlyer said that in today's markets there were unprecedentedly low fares. The advent of low-cost carriers had affected fares not only on the routes operated by these carriers but had changed consumer perceptions of the cost of air travel. CityFlyer now offered fares at lower levels than at any previous time.

Effects of the proposed merger

Competition between BA and CityFlyer

6.152. CityFlyer submitted that it and BA were already so closely integrated that the merger would bring about consequences broadly similar to those which already applied. Passengers would be likely to see no difference in the products offered or in the prices charged. The change in status from franchisee to subsidiary would bring no change in the way the market operated.

6.153. CityFlyer said that there was some limited competition between it and BA on the seven overlap routes which CityFlyer served from Gatwick and BA from Heathrow. This competition was not on price but largely on the basis of catchment areas which lay between the airports. For example, passengers in areas like Guildford, Farnborough and Woking would have similar travel times to either airport. However, CityFlyer's Gatwick services also competed with those of others at Heathrow such as Lufthansa, British Midland, Aer Lingus, KLM and Swissair.

6.154. With the exception of Cologne, Jersey and Luxembourg, the overall frequency of service available from Heathrow on the overlap routes was higher than from Gatwick. In reality, the majority of passengers in marginal catchment areas would opt for Heathrow on the grounds of greater flexibility in departure times and choice of carrier. From time to time there was also competition on fares for price-sensitive passengers (for example, differing levels of promotional offers on parallel routes from Heathrow and Gatwick). However, where BA itself operated parallel routes from Heathrow and Gatwick, it sometimes charged different promotional fares. These differences reflected market conditions and levels of competition at the respective airports.

6.155. CityFlyer had introduced the majority of the overlap routes since the franchise agreement in 1993. BA derived substantial benefits from CityFlyer's operations in terms of connecting passengers. In franchising CityFlyer to operate a service from Gatwick to a destination already served by BA mainline from Heathrow, BA had accepted that it would gain more revenue from connecting passengers delivered by CityFlyer at Gatwick than it would lose through competition in the small area of overlap between the respective Heathrow and Gatwick catchment areas.

6.156. CityFlyer told us that BA had never refused it permission to operate an overlap route. Asked about its proposal to begin a Gatwick-Isle of Man service, CityFlyer said that it considered there had been neither material debate nor material disagreement with BA about this route. In 1997 when CityFlyer had first asked BA if it would be prepared to license the route, there had certainly been a reticence on BA's part to permit the service and the initial reaction had therefore been negative. However, CityFlyer had decided entirely of its own volition to drop the proposal [*Details omitted. See note on page iv.*]

6.157. CityFlyer said that BA had clearly indicated that internal competition was a sensible, commercially-driven strategy with the establishment of its low-fare airline Go, which operated seven routes from Stansted, all of which overlapped with BA mainline services from Heathrow. Furthermore, BA's average aircraft size and its cost base meant that it was unable to compete in a market where CityFlyer could operate profitably.

6.158. On the majority of the 12 routes currently served by CityFlyer from Gatwick, there was abundant evidence of new entry, expansion and exit by carriers other than BA and CityFlyer. This competitive activity might be expected to continue and intensify, in part because of the increasing attractiveness of the three newer London airports engaged in scheduled airline activity within south-east England.

6.159. In CityFlyer's view, its business as it currently stood brought benefits to passengers and to BA through competitive strategies on product development and price which CityFlyer had used to expand its services. The most probable outcome of the merger would be continuity of those services, subject to perhaps marginal reallocation of slots at Gatwick, in order to maintain and enhance the services already provided by CityFlyer and BA.

6.160. CityFlyer contended that, to the extent that CityFlyer secured a stronger financial base for future operations, that must act as a benefit to passengers in each of the markets in which CityFlyer and BA operated. Again, BA might be expected to use that stronger financial base to develop the business.

6.161. CityFlyer submitted that the effect on the competitive process in the market for scheduled air services in south-east England would be nil. One or more competitors might see commercial value to their operations if CityFlyer's business were acquired by them rather than BA. However, CityFlyer took the view that it could not be seriously argued that within the market as a whole, prices would be higher, choice lower or the competitive process distorted.

Slots at Gatwick

6.162. CityFlyer told us that, along with other airlines, it actively participated in the discussions between GAL, ACL and the air traffic control function at Gatwick to establish the number of movements which could safely be allowed on the runway without causing excessive delays for either departing or arriving aircraft. The process did not carry special privilege in terms of priority to any new slots created, as these were allocated in accordance with the EC slot allocation regulation. CityFlyer believed that its participation had benefited all Gatwick airline operators equally.

6.163. CityFlyer told us that its average number of slots used per week in the year to 30 March 1992 was 96; by 30 September 1998 this had grown to 592. Key events affecting Gatwick such as the collapse of Air Europe and Dan-Air and the change in the TDRs had all provided growth opportunities for CityFlyer and other airlines to expand their slot portfolios, if they chose to do so. However, the majority of the growth in CityFlyer's slots since 1991 had been achieved in two ways. First, CityFlyer had accepted slots at less than commercially optimal timings in the hope of obtaining improvements to these slots in subsequent scheduling seasons. Second, CityFlyer had retained flexibility to capitalize quickly on slot opportunities if other carriers cut back or withdrew services and thus released slots.

6.164. CityFlyer said that its willingness to accept less commercially viable slots had been a key part of its ongoing ability to grow. Historically, seats on early morning departures from Gatwick on business routes had proved difficult to sell, so CityFlyer's first daily departures from Gatwick in 1993 were at 0755. Currently its earliest departure was at 0655, but it had accepted that it would have to operate at this earlier time and accept the reduced profitability of that particular flight.

6.165. The benefit was that CityFlyer would earn historical rights to the 0655 slot for subsequent seasons. Under the EC slot allocation regulation, the retiming of a historical slot had higher priority than applications for new slots, so there was a strong chance that CityFlyer would be able to improve the slot to a more viable departure time in the following year should new slots in the peak hours become available. CityFlyer was prepared to accept this clear commercial disadvantage in the short term while it waited to achieve the optimum slot which would provide benefits in the longer term.

6.166. This slot strategy was by no means unique to CityFlyer. Airlines which deployed it had to be patient and be prepared to invest in competent staff to manage the slot portfolios and attend biannual IATA schedule coordination conferences. CityFlyer believed these investments were justified by the resulting growth in its slot portfolio. Airlines which did not make this kind of investment often complained most vociferously about lack of slots. Some carriers did not accept the system whereby they might have to accept less than ideal slots to begin with, then gradually improve them as opportunities arose over time. For example, Continental and US Airways had recently been in dispute over the allocation of some less than commercially optimal (but, in CityFlyer's view, operable) slots. These carriers had now received slots acceptable to them and had confirmed that they would start new routes from Gatwick during summer 1999. CityFlyer said this demonstrated that the system worked.

6.167. CityFlyer told us that the establishment and growth of its slot portfolio had not been an exclusive opportunity. Its slots had not come from BA and any carrier could have taken advantage of the available slots at Gatwick to establish a presence in recent years and expand it through the means described in paragraphs 6.162 to 6.166. Some operators, such as Jersey European Airways (JEA) and AB Airlines (AB), had done exactly that. JEA had held no slots at Gatwick in early 1991 and yet had 202 slots per week for summer 1999, whilst AB had started operations at Gatwick in 1995 and held 106 slots per week for summer 1999.

6.168. CityFlyer had adhered to its business plan to grow its operation at Gatwick, whereas a number of other operators had obtained sufficient slots for their planned operations at Gatwick and had thereafter concentrated on opportunities elsewhere, in some cases having subsequently given up slots at Gatwick (for example, Virgin Atlantic to focus on services at Heathrow, JEA to focus on Birmingham and elsewhere, and AB had been allocated slots which it had then sold).

6.169. CityFlyer maintained that modest entry and growth was still possible at Gatwick, perhaps at the rate of one aircraft a year (ie about 40 to 50 slots a week depending on how intensive the operation was).

6.170. CityFlyer said that it was common knowledge in the industry that an airline could increase its slot portfolio through trading in slots. CityFlyer itself had never acquired or divested slots for cash or other consideration. All its slots had either been allocated by ACL or been acquired legitimately through swaps with other airlines.

6.171. On whether slots could be seen as constituting an economic market, CityFlyer took the view that slots were just one of the many elements of capacity that any airline had to have in order to do business. It was possible to see slots as an element of capacity in order to sell a product. Slot values differed according to usefulness but they could not constitute a market since they did not satisfy the criteria of either the demand or supply side.

6.172. Moreover it would not be right for the merger to be examined in terms of slots alone. Slots did not have a defined value and were returned to the pool if they did not prove to be generating sufficient value. A more relevant consideration was how the slots were used. After the merger with BA, CityFlyer's slots would be used for a purpose in which there was a serious public interest: the maintenance and promotion of competitive conditions in scheduled short-haul services.

6.173. CityFlyer submitted that the proposed merger was entirely different to the merger between BA and BCal which the MMC had considered in 1987 and in which the concentration of slots had been a concern. BA and BCal had been genuine competitors operating many important parallel routes. The market was at that time still subject to regulation: route licences were required and it was therefore not open to other airlines to compete on the routes in question.

6.174. CityFlyer's slots for summer 1999 would amount to 686 a week. Its slot holding was equivalent to 11.6 per cent of the total slots available at Gatwick, but only 2.78 per cent of the total slots available at the five major airports in south-east England. (Additional capacity was available at airports in the South-East which were not coordinated, for example Biggin Hill, Manston, Ashford (Lydd) and Southend.) Overall provision of scheduled services in the South-East could not be influenced to any degree by the disposition of CityFlyer's slots. There was still runway capacity open in south-east England to accommodate new operations or significant expansion of existing operations.

6.175. CityFlyer did not accept the view that the merger should be examined in terms of the number of scheduled slots at Gatwick which would be controlled by the merged company. Most slots, including increasingly those in the very peak hours, could be used either for scheduled or charter services. Indeed, slots between 0500 and 0600 were in great demand for both long-haul scheduled arrivals and for charter operations.

6.176. Neither did CityFlyer accept that the merger should be examined on the basis of the merged company's share of slots in the peak hours. A more relevant consideration was how the acquirer of the slots would use them for the purposes of competing.

6.177. CityFlyer argued that its slot portfolio could not be used to mount an independent hub-and-spoke operation at Gatwick in competition to BA. Gatwick's single runway placed it at a significant disadvantage compared with other European hubs like Amsterdam, Paris and even Heathrow. A hub operation was dependent upon the ability to fly a concentrated wave of arrivals followed by a concentrated wave of departures. This was simply not possible at Gatwick given the lack of availability of large numbers of slots in any time period and the need to balance the numbers of arrivals and departures per period of time to achieve optimum use of the runway. Using CityFlyer's existing slot portfolio to start an independent hub would require significant retiming of slots to achieve the critical mass of flights needed to form a hub wave. This was not possible without a radical change in the usage pattern or number of runways at Gatwick. However, the opportunity did exist for a carrier with the necessary vision to develop a hub at Stansted to compete with BA's hub at Gatwick.

6.178. CityFlyer expected that after the merger it would get the opportunity to take on marginal BA mainline routes which BA would not have licensed to CityFlyer as a franchisee. It might also use its smaller aircraft to operate some frequencies (for example, in the middle of the day) on BA mainline routes.

6.179. CityFlyer believed that BA intended to keep CityFlyer operating as a separate entity, flying its existing network, with normal variations from time to time to accommodate changes in market circumstances, expansion opportunities arising, etc. It made economic sense for BA to do this, taking the overall BA network at Gatwick into consideration. CityFlyer did not believe that any material changes to the use of slots would arise from the merger save for these purposes. CityFlyer understood that its slots would continue to be held in ACL's database under its own designator (FD), not under BA's, and that CityFlyer's own staff would continue to manage the process of acquiring and exchanging its slots.

6.180. CityFlyer's slots were currently used to operate what were, to all intents and purposes, BA scheduled services. The change of shareholder would not alter this. There could, as was already the case, be some swapping of slots between CityFlyer and BA at the margin of their respective operations to improve each company's operational efficiencies to the benefit of both companies and customers. The proportion of slots at Gatwick and in south-east England operated by BA branded services would not change as a result of the merger.

6.181. On whether the merger would foreclose competition, CityFlyer said that the number of slots at Gatwick, barring possible increases in runway movement rates, would be the same before and after the merger.

Night-time operations at Gatwick

6.182. CityFlyer told us that it had a very modest requirement for night-time operations, for its small charter operation providing capacity to independent tour operators. However, CityFlyer's aircraft used up very little QC and so about 90 per cent was handed back after the initial allocation. CityFlyer told us that the degree to which it used its allocations would not be affected by the merger. QC was in any event freely transferable between airlines so BA and CityFlyer would be free to exchange it now if they so wished.

6.183. On the use of strategic delay in the handing back of slots as a weapon against other airlines (see paragraphs 7.10 and 7.23), CityFlyer said that this would not be allowed under the local rules at Gatwick. Moreover, CityFlyer and BA had a responsible attitude towards their allocations and would not engage in this kind of tactic.

6.184. CityFlyer said that it was well disposed towards the proposed new system to allocate night movements and QC at Gatwick according to historic use rather than VPP, but this would not be affected in any way by the merger.

Facilities at Gatwick

6.185. CityFlyer told us that in recent years GAL had been successful in running the airport in a cooperative manner. Airlines were consulted on issues relating to facilities and any problems were usually solved without the necessity for a vote in the AOC. When airlines did vote on such matters, it was in an advisory capacity only and final decisions were taken by GAL as the arbiter of access to all airport facilities, including terminal distribution.

6.186. BA did not have any privileged position in respect of facilities. Indeed because of the design of the North Terminal BA's proportion of pier-served stands was actually much less than it would be entitled to by virtue of its size, VPP or movements at the airport.

6.187. There was no shortage of stands for washing aircraft at Gatwick.

6.188. Hangar space was currently in short supply at Gatwick but this was not because of any particular dominance by BA. The former Dan-Air hangar which could accommodate B747 aircraft had stood empty for four years from 1993.

6.189. CityFlyer told us that it had always been its view that co-location of its services with BA's in the North Terminal was desirable, in order to reduce connecting times and to remove duplication of facilities. Largely at CityFlyer's behest, there was a requirement in the 1993 franchise agreement for BA to use reasonable endeavours, consistent with BA's own interests, to persuade GAL to move CityFlyer to the North Terminal.

6.190. Since 1993 there had been practical obstacles to such a move and also some changes to the South Terminal facilities and cost efficiencies which would partly negate the benefits. It remained the case, however, that if CityFlyer could move to the same terminal as BA without loss of pier service and cost advantages currently available to it, then it would undoubtedly do so. However, this was unlikely to happen in the short term. GAL was the ultimate arbiter in these matters and CityFlyer could not move unless there were sufficient space and GAL agreed to the move.

Travel agents and frequent flyer programmes

6.191. CityFlyer said that it was already a full participant in BA's frequent flyer programmes. It did not participate in BA's loyalty schemes for travel agents and corporate customers but believed it would be able to do so after the merger if it wished. It currently doubted that there would be much advantage in doing so, given the disparity between the size of its and BA's sales growth rates and given the huge disparity in revenues.

Employment

6.192. CityFlyer told us that as at December 1998 the company employed 677 staff, of which 29 were part-time and four were engineering apprentices at college.

6.193. In addition to employment in the company itself, CityFlyer was responsible for the creation and maintenance of many jobs at its contractors. These were mainly handling agency staff and catering and cleaning staff at Gatwick and elsewhere, and employees at organizations which undertook heavy maintenance work on the aircraft. CityFlyer had not been able accurately to quantify how many jobs this amounted to, but it ran to several hundred. There was no intention to vary existing arrangements with contractors as a result of the proposed merger. Furthermore, as a major customer for British Aerospace's Avro RJ100 aircraft the company supported many UK-based jobs in that organization.

6.194. CityFlyer told us that the effect of the merger would be positive in a number of areas. Based on the public assurance by BA's Chief Executive to the effect that no job losses would arise as a result of the merger and BA's efforts to ensure the continuity in CityFlyer's senior management,

CityFlyer was completely convinced that BA had no intention of either downsizing the company or merging it into BA. It would remain and be operated as a separate unit in the same way as Brymon.

6.195. By virtue of BA ownership, CityFlyer staff would perceive it to be a more secure employer than previously. This would be good for morale and for recruitment and in turn would lead to even higher levels of customer service than those currently provided.

6.196. If the merger did not go ahead there would be a period of uncertainty which would leave the company vulnerable to losing certain categories of staff with readily transferable skills, for example avionics engineers.

Benefits of the proposed merger

6.197. In CityFlyer's view, the business currently brought benefits to passengers and to BA through the competitive strategies on product development and price which CityFlyer had used to expand its services. The most probable outcome of the merger would be continuity of those services, subject perhaps to marginal reallocation of slots at Gatwick in order to maintain and enhance the services provided by CityFlyer and BA.

6.198. More than 20 per cent of CityFlyer's passengers transferred to BA flights. CityFlyer therefore acted as a vehicle for improving the competitiveness of BA at Gatwick in hub-to-hub markets in which the interests of Gatwick were as much affected as the interests of BA.

6.199. To the extent that CityFlyer secured a stronger financial base for future operations, that must act as a benefit to passengers in each of the markets in which CityFlyer and BA operated. BA might be expected to use that stronger financial base to develop the business.

Other possible outcomes in the absence of the merger

6.200. On what would happen if the merger did not go ahead, CityFlyer said that it had moved into a position where it was extremely vulnerable. The institutional investors would still want to divest. Their advisers HSBC had not identified any other institutional purchasers likely to invest in CityFlyer for income purposes. In a climate of uncertainty as to the future ownership, BA's attitude to the franchise might change and it was at least questionable that BA would renew the agreement at the end of 1999. There would be a period of great uncertainty and—in a fairly mobile industry—it was very likely that staff would leave. This could lead to a difficult downward spiral and CityFlyer found it very difficult to predict how it would end. In summary, it was not open to CityFlyer to determine what would happen if the merger were prohibited. Its future did not lie in its own hands; it lay in the hands of the institutional investors and of BA.

6.201. On whether it could succeed as an independent short-haul operator, CityFlyer said that it was not possible to replicate at Gatwick British Midland's position at Heathrow. British Midland had exploited a unique opportunity offered by the TDRs to build up a point-to-point network from Heathrow. It had used its own strong brand to develop that position and then entered code-share arrangements with a wide range of long-haul operators. This opportunity did not exist at Gatwick, which was smaller and had insufficient long-haul carriers apart from BA. Moreover CityFlyer had no brand of its own, having relied on BA's.

Virgin Atlantic's proposals for CityFlyer

6.202. [

Details omitted. See note on page iv.

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6.203. [

Details omitted. See note on page iv.

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6.204. [

Details omitted. See note on page iv.

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6.205. CityFlyer submitted that there was no means by which the Commission could apply a test of probability to the consequences in the event of Virgin Atlantic buying CityFlyer.

Remedies

6.206. On the hypothetical basis that the proposed merger was held to be against the public interest, we asked CityFlyer about a number of possible remedies short of prohibition. CityFlyer emphasized that it was not in favour of any conditions being imposed, not only because there was no basis for them but also because this would entitle BA, if it so wished, to withdraw from the transaction.

6.207. CityFlyer considered that if the merger were conditional upon the divestment by BA of an amount of slots equivalent to all the slots currently used by CityFlyer, this would not be materially different from prohibition of the merger.

6.208. In discussing various options relating to slots, CityFlyer made the general point that any remedies would need to be workable from the point of view of ACL, whose allocation system was already complex.

6.209. On ring-fencing CityFlyer slots so that they could be used for broadly the same purposes as at present, CityFlyer considered that ring-fencing by reference to the current CityFlyer routes would be a damaging constraint on the company's commercial development. It needed to retain freedom after the merger to alter and develop its route network according to market circumstances. However, CityFlyer did not object to ring-fencing of CityFlyer's slots (which after the merger would still be held in ACL's database under the CityFlyer code FD) by reference to their use on short-haul services, for example intra-EEA, as long as CityFlyer was still able to carry out legitimate slot swaps etc as required to adjust schedules.

6.210. On BA being required to undertake that it would not use CityFlyer slots for a route already operated by BA mainline or its subsidiaries, CityFlyer took the view that this was a matter for BA but that it would be likely to amount to unnecessary interference in the working of the market.

6.211. In response to the proposal that BA be required to return one slot to the pool every time it diverted a CityFlyer slot for use on a long-haul route, CityFlyer took the view that this was a matter for BA but, so far as CityFlyer was concerned, it had no objection.

6.212. On a cap being imposed on the total slots to be held by BA and its subsidiaries at Gatwick (for example, 45 per cent of total slots), CityFlyer said that this was a matter for BA to comment on. Whilst a ceiling of 45 per cent would give the merged company some headroom, CityFlyer considered that this would give an uncovenanted benefit to competitors operating from Stansted, Luton and City. It would be harsh regulation which would curb the ability of the merged company to meet market opportunities if the other suppliers were less competitive in meeting market demand. In any event, as well-established operators BA and CityFlyer were already at a disadvantage by virtue of the EC slot allocation regulation, which operated in favour of new entrants.

6.213. CityFlyer took the view that it would be very difficult as well as unwarranted to impose remedies relating to night-time operations and facilities at Gatwick.

CityFlyer's institutional shareholders

6.214. 3i gave evidence in writing, and also at a hearing together with the shareholders' advisers, HSBC, on behalf of the investment institutions which were founder shareholders of CityFlyer. These institutions were 3i, Friends Ivory & Sime Private Equity PLC, Gresham Trust PLC and Mercury Grosvenor Trust PLC. Together they represented a collective holding of 63.75 per cent of CityFlyer's share capital.

6.215. 3i told us that the institutions represented a significant share of the UK venture capital market and supported the development and growth of a large number of British businesses. Ultimately, their objective was to maximize value from their investments. They had invested in CityFlyer during an economic recession and in a sector notorious for cyclicalities and business failure. At that stage, no franchise had existed with BA and the business had been viewed as high risk.

6.216. 3i said that if the institutions found themselves unable to exit because of regulatory hurdles, having pursued an open process of seeking acquirers for the business, this would inhibit the preparedness of financial institutions to take such risks in future.

6.217. The institutions had an open mind as to the future development of the business. However, having supported CityFlyer through the start-up phase, they were keen to see it under ownership which would allow it to continue to grow and develop successfully.

6.218. HSBC told us that it had initially valued the business in the region of £[] million to £[] million but had aimed to secure a premium above this to reflect the strategic value. At that stage HSBC had had no clear view as to who the purchasers might be and various alternative acquirers had been approached, to test the market (see paragraphs 3.81 and 6.115).

6.219. Asked about Virgin Atlantic as a potential purchaser, HSBC said that that company had expressed interest in buying CityFlyer at the market testing stage (conducted during the first quarter of 1998) and subsequently in numerous telephone calls made after the shareholders of CityFlyer had received an offer of £75 million for the company from BA, which had required a period of exclusivity to complete negotiations. Virgin Atlantic had not, however, made a formal bid until 1 March 1999.

6.220. Virgin Atlantic had specifically stated at the outset in January 1998 that it would not be used as a stalking horse against BA and would not enter a competitive auction. When asked by Virgin Atlantic to indicate the price for CityFlyer, HSBC had declined because it intended the price to be determined by the market. Later in the process, when negotiations with BA had almost been concluded and there was press speculation that BA was about to acquire CityFlyer, Virgin Atlantic had indicated that it was willing to offer more than BA. [*Details omitted. See note on page iv.*]

6.221. [

Details omitted. See note on page iv.

]

6.222. On 1 March 1999 Virgin Atlantic dispatched a written offer to CityFlyer shareholders to 'step into BA's shoes' and buy the company for £75 million. 3i told us that the shareholders were contractually committed to sell to BA. However, they took this formal offer from Virgin Atlantic seriously and were exploring whether it constituted a deliverable alternative, should the transaction

with BA not proceed for regulatory reasons. The legal advisers acting for CityFlyer's institutional shareholders subsequently briefed the Commission on further communications with Virgin Atlantic (see paragraphs 3.83 and 3.84 and Appendix 3.5).