5 Views of CHC

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The merger

5.1. CHC told us that in mid-1998 it had considered the strategic options open to it for the future of Brintel. The latter had had a particularly bad year, being advised in March of the loss of the major Shell contract to Bristow. The consideration of options had been a continuing process. As there was no prospect of improving rates because the oil companies would not allow them to rise, the only way to improve performance was to improve efficiency. The options had been:

(a) diversification;

(b) rationalization;

(c) consolidation (ie sell the operation or buy another operator); and

(d) close it down.

5.2. Rationalization had at first been the main course followed. The operation was shrunk and staff numbers reduced: some ad hoc business had also been obtained which helped to keep the operation alive. CHC also offered in meetings with HSG and Schreiner in July 1998 and again with HSG in December 1998 to sell Brintel. Schreiner was not attracted to a purchase of the overhead and helicopter assets of Brintel at Aberdeen and CHC received no reply after the December meeting with HSG. Closing Brintel was viewed as very much a last resort. Costs of exiting from the UK market were high and the loss of such a significant part of its business would have been a heavy blow to the CHC group.

5.3. CHC told us that in the last decade there had been a marked decline in the demand for offshore services worldwide. The oil companies had themselves engaged in consolidation and pursuing efficiencies. In order to restore long-term profitability operators must pursue economies and efficiencies through consolidation. CHC said that it had first identified HSG as a potential acquisition in late January 1999. The HSG share price had fallen by around 65 per cent over the previous 12 months to a level where the company's market capitalization was below book value. There was no dominant shareholder in HSG to be bought out and CHC had reason to believe that a major US shareholder would be happy to sell. The two groups would make a good strategic fit on a global basis. The fact that the two were in head-to-head competition in few places outside the UK meant that the combined group would have a much wider range of markets open to it. Their sizeable UK operations would yield economies through rationalization of overhead costs. Brintel provided details showing that the anticipated overhead savings

from the merger of Brintel and Bond would amount to approximately £6.5 million. CHC believed that consolidation in the offshore helicopter market was inevitable. The sale in 1998/99 of its repair and overhaul company, Vector Aerospace Corporation, gave CHC additional funds and financial flexibility for such an acquisition. That the purchase of HSG was opportunistic in no way reduced its strategic significance to CHC.

5.4. We asked whether HSG could have survived as a separate company. CHC thought that was hard to judge. HSG too had been hit by the decline in the offshore market, on which HSG was particularly reliant. The due diligence carried out by CHC during the merger process had revealed that HSG was in breach of its banking covenants as at the end of April 1999 and had to obtain a temporary waiver from its banks, though CHC did not believe that the breach had materially endangered HSG's solvency.

5.5. We asked CHC whether the description used of a 'merger of equals' in a press notice issued jointly with HSG on 18 June had any particular implications for the merger. We were told that it had not. The HSG board had been concerned about the potential disappearance of its Oslo head office and how HSG employees might be treated after a change of control. The press notice and other measures implemented by CHC and HSG had been an attempt to provide reassurance to HSG personnel about the likely consequences of the merger. CHC was anxious to maintain goodwill of the Norwegian staff, who were being treated on a footing of equality of opportunity in the enlarged group: those who had left had been fairly treated in their severance arrangements. An office was being maintained in Oslo under the previous manager; continuity was also the case in other areas, such as South Africa. However, the transaction was unambiguously an acquisition of HSG by CHC.

Market definition

5.6. CHC considered the UK North Sea Northern Zone to be both a distinct market and the correct geographic market. It was not commercially or operationally viable to service Northern Zone installations from Southern Zone facilities, due to such factors as the customer's preferred departure point and a helicopter's range and payload. CHC believed that geographic markets were inherently local because of the need for proximity between where helicopters were stationed and the offshore facilities to be serviced. However, precisely defining the market was not in itself necessarily the best way of ensuring that the competitive constraints that would continue to be operative after the merger were properly analysed.

5.7. We asked whether the merger could be seen as reducing competition in the North Sea Southern Zone also: Brintel had continued to bid for business there. CHC commented that there were always potential entrants for both zones and that the main issues for consideration (barriers to entry, buyer power, demand trends and the extent of competition) were much the same whatever the geographic market.

Barriers to entry

5.8. CHC argued that barriers to entry into the market were materially lower than at the time of the 1992 report, for a number of reasons.

5.9. The liberalization of the EEA market through the 'third package' of regulations (particularly of Regulation EEC 2407/92 on the licensing of air carriers) from 1 January 1993 had made an important difference. The effect of the package was that arrangements for co-operation, particularly joint ventures, could now much more readily be entered into between non-EEA operators and EEA operators, ie those in which there was majority ownership and effective control by member states or their nationals, with up to a 49 per cent interest on the part of the non-EEA partner. Furthermore, EEA liberalization increased the number of potential joint venture partners with which a non-EEA operator could join in order to enter a market, including the UK. The 49 per cent holding by the US operator OLOG in Bristow Helicopters was the clearest example. Another was the joint venture between KLM and Era of the USA for a Shell contract in the UK Southern Zone between 1995 and 1998. PHI of the USA had also operated for a period in a former joint venture with Bristow, Irish Helicopters. The fact that Era and PHI were no longer active in the UK and Irish offshore markets was not in itself significant. Both Era and PHI remained important potential competitors for CHC. These were large US operators with the necessary industry contacts and expertise, as well as extensive experience of establishing licensing joint ventures in many

parts of the world. OLOG had also made Bristow into a competitor now even more capable of obtaining business in the NWECS market as a whole, as shown by Bristow's shareholding in Norsk Helikopter AS of Norway and Bristow's Netherlands company.

5.10. We asked CHC whether joint ventures were as easy to use as they had argued, in view of, for example, the more complex lines of management responsibility in a joint venture. CHC considered that joint ventures were a well-accepted and -tested organizational format in the international helicopter industry: an instance was its own joint venture in Thailand which had been in operation for 25 years; another was the fairly recent HSG and Cougar Aviation joint venture in Canada to serve the Hibernia project. CHC itself had been involved in many joint ventures worldwide, a consistent feature of which was the leasing in of aircraft, personnel and support services to the locally-based licensed joint venture partner. Whatever the precise nature of the arrangements, the fact was that the EEA liberalization had provided a means for non-EEA operators to establish a presence in the EEA whether in partnership with existing EEA offshore operators or with the many onshore operators also to be found.

5.11. The EEA liberalization had a further significant effect, in CHC's view. That was in facilitating the setting up by a provider of offshore helicopter services established in one EEA member state of a satellite operation in another. The satellite which Brintel had created earlier in the year in Denmark after winning the Maersk Oil and Gas contract from Maersk Helicopters was a case in point. Much of the cost of operating a satellite facility could be absorbed relatively cheaply through the home base overheads, in particular administration and maintenance of the aircraft. That allowed the satellite base to be reduced to the minimum of an adequate hangar (usually leased) and the employment of local aircrew and support staff. It had cost Brintel no more than £200,000 or so to set up its Danish satellite. The sunk costs were thus low, particularly when spread over the period of a contract; that would be no different for a new entrant wishing to service a contract by setting up a satellite base in Aberdeen. Bristow had entered the Norwegian market in comparable fashion in 1994, with only one aircraft. Another example was the recent Irish Helicopters/Schreiner joint venture to operate the Enterprise Oil plc contract in Ireland.

5.12. We put it to CHC that the satellite option and the liberalization package did not change the fact that from the EEA area the only potential entrants of EEA nationality were Schreiner of the Netherlands and the Bond brothers in the UK: the latter were barred by a voluntary non-competition agreement from re-entering the UK offshore market until July 2001. CHC replied that there were other potential parties within the EEA, such as Irish Helicopters and Heli-Union. From outside the EEA, Era and PHI were obvious candidates for joint ventures with EEA operators. There were, in addition, a large number (about 40 in the UK, according to CHC) of onshore helicopter operators: they should not be overlooked. That was particularly so as buyer power made entry a real threat. Oil companies dictated the process by which contracts were awarded and could bring in another supplier if they did not like the terms being offered by those with established bases in the market.

5.13. We asked why, if market entry were so easy, there had been only one example in the UK, the KLM ERA contract for Shell in the Southern Zone, of a joint venture between EEA and non-EEA operators. CHC believed the main reason was that the prices paid to helicopter operators had not been attractive in recent years. The other reason was probably that the oil companies were content with the prices and quality of service being offered by the existing operators. If the oil companies ceased to be content then they had it in their power at any time to bring in competitors, whether other EEA operators or from outside the EEA.

5.14. We asked CHC whether the availability of aircraft and qualified pilots, bearing in mind such factors as the need to purchase the licence rights to modify aircraft to fit them for North Sea operation, tended to impede entry into the market. CHC said that new helicopters could be obtained from Eurocopter in about ten months from order. New aircraft had the advantage that many of the special North Sea modifications could be incorporated during manufacture, thus saving time, as well as the growing preference of the oil companies for new aircraft. As for second-hand aircraft, the more likely source for an entrant, there were a number of Super Pumas already available for purchase, for example in Thailand, or one from Eurocopter. Furthermore, leasing of aircraft between helicopter operators was common practice. The aircraft were a heavy capital cost in an operator's overhead and experience confirmed that when an operator lost a contract of any importance it would naturally look to lease (or even sell) its spare aircraft. When asked, CHC said it was not true that CHC had been unwilling to lease helicopters to Bristow when Brintel lost the Shell contract: on the contrary, it had offered three Super

Pumas to Bristow at market rates but Bristow had decided to obtain the necessary helicopters from other sources including Bond.

5.15. As for availability of pilots, there was no problem in the short term. Bristow had, for example, recently laid off a number of pilots. The synergies available from the merger would also release a further number. However, the prospective supply of pilots in the longer term was not as certain. A significant number of pilots were approaching the normal industry retirement age of 55 to 58. Younger pilots were not coming forward in sufficient numbers to replace those retiring. The operators such as CHC would have to invest more in training pilots and depend less on supply from sources such as the Royal Air Force.

5.16. CHC told us that an important consideration in the 1992 report no longer applied. That was the availability of hangarage and related facilities at Aberdeen Airport. Bond in that inquiry had not envisaged that its acquisition of Brintel would lead to surplus hangarage becoming available. However, at this time the decline in the size of the market meant that most of the existing Bond capacity would be available for release to another operator in view of the intention to locate the greater part of the merged operation within the existing Brintel facilities. The airport management was anxious that the surplus facilities be made available to other users. Moreover, CHC itself was prepared to offer undertakings, in the event of the CC finding that there were detriments to the public interest arising from the merger, to lease or sell suitable hangarage or to place it under the control of a third party such as the airport authority; to allow the use of Brintel's terminal facility; the use of Brintel's maintenance and training services; and the lease or sale, as appropriate, of any available aircraft from CHC's UK fleet. Furthermore, CHC emphasized that these facilities and services could be made available by it at Aberdeen on reasonable market terms, the final determination of which could be settled by an independent third party. Extending that offer to the Bond brothers also, in the event of their wishing to re-enter the offshore market, might be more difficult but would be acceptable if they did not have to share the same facilities. At present BAS was for its onshore operations sharing CHC facilities. If BAS was competing with CHC in the offshore market, such sharing could be disruptive of both the CHC and BAS operations, unless BAS were to occupy separate space (which was available). However, it was not clear to CHC why if the Bonds were released from their non-compete agreement or re-entered the market after it had terminated they could not find facilities entirely separate from those also occupied by CHC.

5.17. CHC also argued that the process by which entry and potential entry acted as a competitive constraint was different from that considered in 1992. That process was seen by the MMC as one in which a new operator would first acquire assets and licences to establish itself as a base and from there bid for contracts. Now operators bid for contracts and if they won put together the assets needed to service them. Lead times on bids were controlled by the oil companies and could be such that helicopter service providers need commit no resources until they knew they had obtained the work. Oil companies permitted operators to bid and awarded contracts to operators without the necessary assets already in place.

Demand trends

5.18. CHC argued that the decline in the UK market in recent years seemed likely to continue unless there were an increase in exploration followed by increased production: it was production which created more demand for helicopter services. Looking ahead, and allowing for all the uncertainties, the UKCS seemed likely to continue declining as a source of helicopter demand: the Norwegian area of the NWECS would probably remain fairly steady. In fact, it was not easy to see many areas of prospective demand growth around the world.

5.19. We put it to CHC that the data in the report by SREA commissioned by Brintel in fact showed that the UK market, as measured by flying hours, had declined between 1992 and 1994 but had remained more or less stable since then until 1998. We asked whether the fact that three helicopter companies had been able to survive during that period implied that three could have continued to operate profitably, subject to a necessary degree of rationalization and cost cutting to take account of the fall in demand for 1999. In addition, CHC's emphasis on the constant threat of potential entry into the market, even after the merger, by other operators such as Era or Schreiner implied that the market could sustain three operators: it was not at first sight easy to reconcile that position with CHC's view that departure from the market by one of the three UK operators was largely inevitable.

5.20. CHC did not see any inconsistency in its argument. Brintel had made significant economies in its Aberdeen operation after the loss of the Shell contract. But there were limits to how far that process could have been taken without weakening the company so much that it no longer remained viable. There were three operators in Aberdeen all with overhead costs to recover but the level and profitability of the available business was not sufficient to sustain all three indefinitely. The attraction of the merger was that it would enable two overheads (Brintel's and Bond's) to be compressed into one. If they supplied services to the UKCS only, the Northern Zone could sustain at most two operators with overhead and the Southern Zone perhaps only one. Either market would, however, remain contestable with two operators which had established bases there because the oil companies had it constantly in their power to attract other competitors. These would be able to offer helicopter services economically, perhaps through the use of a satellite facility in Aberdeen as Brintel had done in Denmark. In fact, the market could sustain at least five operators if all their overhead costs were covered either through offshore contracts elsewhere or through supplying other kinds of services, which would include those with satellite bases in that market.

Buyer power

5.21. CHC told us that the buyer power of the oil companies was considerable, tending to grow constantly and a powerful check on the ability of a duopoly to influence the market in favour of the two suppliers. It was CHC's firm view that whilst after the merger there would be two operators with established bases in the Northern Zone, there would not be a duopoly due to the strong competitive constraints imposed by *(a)* potential entrants, having regard to the fact that competition was for the market, and *(b)* the bidding process. Both were enhanced by purchaser power. Therefore, even with the rationalization that the merger would permit, the helicopter operators would still have surplus capacity which would be reflected in the power of the oil companies to obtain market terms to their advantage.

5.22. That power stemmed, in CHC's view, from the following factors. The difference in financial scale between the oil companies and their suppliers was substantial; the oil companies were global and consolidation meant they were becoming even larger in financial terms; the size of many oil companies meant that each was a significant customer in percentage terms to a helicopter operator; they could jointly buy services; they had contacts with suppliers all over the world; and they had the financial strength and organizational ability to self-supply if necessary.

5.23. CHC added that buyer power had been evidenced in the shift away from exclusive or sole use contracts, with a fixed rate for a certain usage level and an hourly rate above that level, to pay-as-you-use. That change made the helicopter operators' revenue both less predictable and often lower. The increasing tendency of oil companies to pool their flights, another example of the evidence of buyer power, and to increase the length of shifts on their installations worsened the balance between demand and supply in the offshore helicopter services market, to the advantage of the oil companies. Even though contracts were usually for around five years, the predictability and stability that provided to the operators was much less than it appeared. Contracts typically had one-way notice clauses allowing the customer to determine the contract on 30 to 90 days' notice. Oil companies did not hesitate, for example by threatening the termination of a contract, to demand more favourable terms when they chose to do so: CHC cited several examples of contracts in which Brintel or Bond had felt obliged to reduce prices or otherwise change contract terms in response to oil company pressure. The contract negotiation process also favoured the oil companies, which used unverifiable claims about terms on offer from other bidders to beat down a helicopter company. The ultimate threat that the oil companies had was the power, entirely within their control, to induce other helicopter operators into the market with the offer of a contract, as Shell had in transferring a Southern Zone contract in 1995 from Brintel to KLM ERA. The loss of Brintel's Northern Zone Shell contract, which accounted for around half Brintel's turnover, to Bristow in 1998 was another example of the oil companies' power; [

Details omitted. See note on page iv.

]. In short, the oil companies had the power of life and death over the helicopter operators.

5.24. We put it to CHC that it, and the small number of other helicopter operators, was providing an essential service to the oil companies. That surely gave the operators some power to defend themselves. CHC considered that the contract process worked against the helicopter operators and was heavily weighted in favour of the customers, no matter how many operators bid. In the view of CHC the experience since 1992 confirmed that the market was transparent for the oil companies alone, even

though it might have been perceived differently at the time of the 1992 report. The mutual dependency argument also worked the other way, in that the helicopter companies had high fixed costs to recover and the oil companies exploited that weakness.

5.25. CHC argued that the global nature of helicopter operators such as itself and OLOG did not offset the power of the oil companies. In some ways it made the operators even more vulnerable. If a major oil company was unhappy with the situation in one market then it was perfectly capable of retaliating against the helicopter operator in another market.

5.26. We asked whether encouraging a new supplier to enter the helicopter market would be seen as only a last resort by an oil company, as it took time and trouble. CHC believed that it was not too difficult for the oil companies. They controlled the timing of the tendering process, whether and when to go out to bid, the timetable for the process and who was invited to bid. They did not necessarily require bidders for a contract to have obtained the necessary licences and other facilities at the time of bidding, as in the case of Brintel's entry into Denmark where Maersk extended the commencement date of the contract to facilitate entry. They knew that aircraft and pilots would be available from an incumbent operator losing a given contract. There were no real administrative or personnel problems in setting up a new operation such as a joint venture since the CAA (and the customer) would be satisfied so long as it judged the new entrant had the necessary handful of key qualified staff with good track records, particularly in safety matters. The presence of such individuals in a new entrant was important also for satisfying the oil companies that its safety standards would be adequate: track records tended to go with individuals rather than companies as such, despite the point in the 1992 report that a helicopter company without a track record would probably not be the supplier of choice for the oil companies.

5.27. We asked about open book contracting, under which the helicopter operator made its cost information available to oil companies so that it could assess whether it was being overcharged. CHC said that open book was provided for in its BP and Mobil contracts but not so far used. CHC had no problem with open book contracting. But if it did become more general then it would be because the oil companies were using the system as yet another means of forcing helicopter operators' prices as low as possible.

Extent of competition

5.28. We asked CHC about the competition in the market, in particular between itself and OLOG, and whether competition might be seen as likely to diminish after the merger. CHC did not consider that would be so. The oil companies would ensure that the market remained very competitive. Buyer power meant that, in addition, potential entry was a real threat. All that an oil company needed was a threat of entry when the bidding process was due to begin for any contract. The costs of putting together a bid were not high (about two weeks' work for two people) and a bidder not in the market knew that with the award of a contract he could readily obtain the assets needed to carry it out by the time of its commencement date. The oil companies switched contracts from suppliers who had been fulfilling them for a very long time if they could obtain marginal price advantages from another helicopter operator and had no hesitation in reminding operators of that threat when contracts came up for renewal. CHC believed that the experience of the Norwegian market showed that the presence of only two competitors with established bases did not necessarily imply that prices would be higher and provided us with research it had commissioned from Lexecon to the effect that Norwegian and UK helicopter rates were very similar, notwithstanding that Norway had two operators with established bases and the UK three.

5.29. We asked whether CHC had any knowledge about the costs of other operators such as Bristow; it might be thought that in such a concentrated sector costs would be rather similar and known as such to the operators, thus reducing uncertainty in their competitive behaviour. CHC considered that costs of different operators were not necessarily very similar. Pilots constituted the only cost element that could be expected not to vary greatly. But between, say, Bristow and Brintel/Bond, many items of cost could differ considerably; for example, Bristow had its headquarters in Surrey and CHC had no idea what difference that might make to its costs. Relationships between helicopter operators were not good, in the sense that they were competitors. They limited information about their pricing to a very small group of people within each company and any discussions that the operators held were confined to narrow areas such as safety or a specific operational need such as the short-term hiring of a helicopter.

5.30. We asked CHC about the sale of helicopters; its press releases during the takeover had envisaged that surplus HSG helicopters would be sold in the event of its being completed. CHC told us that it had concluded an agreement on 30 July to sell 12 helicopters to OLOG and Bristow for some $US[✄] million and disclosed to us the terms of the implementing agreement. (Fuller details of the agreement are in Appendix 3.1, paragraphs 28 to 34.) CHC had decided to initiate discussions exclusively with OLOG due to shortage of time and the fact that OLOG was most likely to have the necessary financial capability to fund the purchases. CHC had had to ensure that funds for the helicopter sales were available to CHC as at 2 August, the date by which it was due to decide whether to make its bid for HSG unconditional. It was simply not practicable to attempt to negotiate with a number of potential buyers in the time available, though CHC would otherwise have had no objection to doing so and would have done so had there been no market through OLOG. The sale arrangement was a purely commercial one though CHC did not hide the fact that OLOG had achieved a favourable deal by requiring some supplementary options on additional aircraft and sectors of the business outside the UK (all at fair market value). Only one aspect of the transaction involved the possible transfer of operational contracts subject to the customer's consent. That was the sale and leaseback of three S61-N helicopters used in a Bond search and rescue contract for the Irish Government Marine Department. However, the purchase of aircraft by OLOG was not conditional on the transfer of the contract and if no customer consent was forthcoming Bond would perform the contract with a market rate leaseback of the relevant aircraft. CHC was uncertain why OLOG and Bristow were so interested in taking over the Irish contract, a not very profitable one; it could only be assumed that Bristow, with its previous experience of the Irish market, thought it could operate it remuneratively.

5.31. We asked CHC about information it had supplied to us showing the markets around the world where it (including HSG) and OLOG were both active. In only five markets (the UK North Sea, Norway, Brazil, Azerbaijan and the Timor Sea) were the two shown as in direct competition. CHC replied that that market data should not be interpreted too narrowly. Markets were often as much regional as national. A presence in one market was often the springboard to bid for business in another national market within the same region. There was a constantly changing pattern of market entry and exit in response to the success or failure of contract bids. Accordingly, the areas which it and OLOG were in (with others such as Era and PHI or local companies such as Malaysia Helicopters) meant that effective competition was much larger than might at first appear to be the case.

5.32. CHC emphasized that the sale agreement with OLOG in no way implied closer operational or other co-operation between the two groups. OLOG had not in any way been a party to CHC's decision to acquire HSG nor in making the transaction happen. They were and would remain competitors in a number of markets around the world. Nor was there any other agreement or relationship, of a financial or other nature, such as a loan, between CHC and OLOG.

Effects of the merger

5.33. We asked CHC about the timing and extent of post-merger rationalization. CHC said that the main factor was the completion of its refurbished terminal building on the west side of Aberdeen Airport. Its estimate was that relocation of the merged facilities should be complete around September or October 2000. As for the integration of staff and management structures, that, too, had been going well until suspended during our inquiry. It was CHC's intention to ensure that the most capable personnel were retained and put to the best possible use irrespective of whether they were former Brintel or Bond employees. The Bond personnel had considerable strengths and at the 'second level' CHC had retained the Bond personnel almost without loss.

5.34. We pointed out to CHC that if the oil companies were as powerful as they claimed, it would surely be difficult for CHC to keep the prospective economies from the merger to invest in new aircraft, training future pilots, etc. CHC hoped to keep the savings but accepted that it would not be easy, given the constant buyer pressure on its terms and conditions. However, CHC believed the oil companies would recognize that it was in their interest also for the operators to earn a reasonable rate of return and invest in continued efficiency and stability. That was the best sense in which merger savings should benefit customers. Whether the merger synergies enabled CHC to reach its target rate of return on total assets of 14 per cent remained to be seen.

5.35. We asked CHC about a reference in board minutes of 7 June 1999 to an assumption of a 1.5 per cent price increase and the statement in its 1999 annual report that the merger would bring about

a better balance within the helicopter services industry. CHC replied that the 1.5 per cent increase was not a forecast of how much it might be able to raise prices after the merger but a hypothesis about the revenue it could expect from index linking, as some contracts allowed increased costs to be passed on. As for balance within the industry, it had had in mind that it was not a healthy situation for one company, Bristow, to have around half of a static market shared between three companies.

5.36. We asked CHC whether it considered that the merger would lead to further concentration within the helicopter services industry. It said that CHC would not be able, for financial reasons, to contemplate further mergers for some time. There was speculation in the industry that the second tier of companies such as PHI might wish to expand by consolidation. If rising oil prices enabled the helicopter services market to expand, there could be other companies attracted into the market and an outcome of anything up to ten global competitors. But if helicopter rates remained largely unchanged around the world the market could end up with three to five global companies.

5.37. Following the merger, CHC believed that there would be no adverse effect on price or quality of service. There would remain strong competitive constraints—the threat of potential entry and intense competition due to the bidding process imposed by the oil companies. In addition, buyer power was considerable and had a significant role to play in both these constraints.