

8 Views of regulatory bodies

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Introduction

8.1. We invited views from a number of regulatory bodies. This chapter summarizes the evidence we received. Oral hearings were held with the CAA and the DETR.

Civil Aviation Authority

Background

8.2. The CAA told us that CityFlyer was the first of BA's franchise operators. Between 1991 and 1993, when the full franchise started, it had already begun operating under a code-sharing and marketing agreement with BA.

8.3. CityFlyer currently served 12 routes from Gatwick, including both UK domestic and intra-EU international. It was the second largest slot holder at Gatwick with 12 per cent of slots in summer 1998 compared with the 30 per cent held by BA and its wholly-owned subsidiary Brymon. So far as scheduled operations were concerned, CityFlyer accounted for 17 per cent of total flights at Gatwick in summer 1998 and BA for 40 per cent.

8.4. Since the liberalization of air services resulting from the EU Third Aviation Package in 1993, there were no longer government-imposed restrictions on market access or on the number of flights, capacity or fares that airlines which were majority owned and effectively controlled by EU nationals or governments could provide on routes within the EU. However, scheduled airline operations on routes to points outside the EU were still governed by the terms of bilateral air services treaties between the UK and other countries. The fundamental rule laid down in these treaties was that before an airline could operate international air services it must be owned and controlled by nationals or the government of the country in which it was established and from which it operated its services. There were normally restrictions also on market access, flight frequency and capacity, and the prices which airlines may charge, although the intensity of these varied considerably.

The implications for existing competition between BA and CityFlyer

8.5. Under the franchise CityFlyer had expanded rapidly and profitably with its passenger carrying increasing from some 240,000 in 1992 to over 1.3 million in 1998. Its aircraft were in BA livery and its on-board service conformed to BA standards. Apart from its use of smaller aircraft types, ATR turboprops with 48 to 66 seats and 92-seat Avro RJ100s, and some slight variations in its fare structure and levels, the airline presented to the passenger a service that was indistinguishable from that of BA. The terms of the franchise agreement allowed CityFlyer a degree of independence in its choice of routes and in its pricing. Indeed, CityFlyer could, if it wished, operate routes in its own right: the fact that it had never taken up this opportunity was presumably a reflection of the benefits it derived from carrying the BA brand.

8.6. Where it operated on a route which was also covered by a BA service from Heathrow, CityFlyer provided an alternative to passengers in the overlapping catchment areas of the two airports but, that apart, there was no competition between the two airlines. If it were to remain a franchisee it was difficult to see that CityFlyer would start a route or price in a way that was against BA's interest. Thus the CAA believed it unlikely that there would be a significant loss of existing competition if the acquisition were to proceed.

Slot scarcity and secondary trading

8.7. Slot allocation at Heathrow and Gatwick was governed by the EC slot regulation. This gave precedence to those airlines with historic rights before assigning a priority to new entrants as regards any remaining slots and any new capacity. Airlines had generally retained slots for which they had historic rights and the number of available slots at commercially attractive times had steadily diminished. Although there had been some increases in capacity at the two airports over time, the number of new slots created each year had been small. Thus, for some considerable time at Heathrow, and in more recent years at Gatwick, demand had exceeded supply and airlines seeking sufficient slots to start a new short-haul service had had little success. More recently at Gatwick airlines requesting even a once-daily pair of slots to start a long-haul service had found difficulty in obtaining operationally viable arrival and/or departure timings.

8.8. The slot regulation allowed the exchange of slots between airlines (including those which occurred as a result of a total or partial takeover) and to some extent a grey market in slots had developed, often based on the 'exchange' of commercially valuable slots for ones in the off-peak hours. This provided a degree of flexibility but had obvious drawbacks. The CAA believed that a clearer focus on achieving economic efficiency through the price mechanism was needed. To this end it had long advocated the formal recognition of a transparent secondary market in slots, subject to such safeguards as might be necessary against any abuse by an airline in a dominant position. However, although such a system would ameliorate some of the difficulties airlines faced at Heathrow and Gatwick, the basic problem was a lack of capacity, and it would still remain.

Possible future outcomes

Identification of main possible outcomes

8.9. The CAA was of the view that the principal concern that led to the referral of the proposed acquisition to the Commission by the Secretary of State was that it might enable BA to foreclose competition from other airlines both through increasing its hub strength and by preventing other airlines acquiring CityFlyer's slots in the future. Whether this was so would to a large extent depend on what other options might be open to CityFlyer if the proposed acquisition were not to proceed and on how BA might choose to continue, or alter, CityFlyer's operations, and the use to which the slots concerned were put, were it to go ahead.

8.10. The CAA had identified as worthy of examination three possible outcomes were the proposed acquisition to go ahead and five if it were not. These were as follows:

Outcomes in the event of BA acquiring CityFlyer

- BA continues to operate CityFlyer as a feed carrier on its existing routes (Outcome A1).
- BA continues to operate CityFlyer as a feed carrier, but modifies its route structure (Outcome A2).
- BA redeploys CityFlyer's slots at Gatwick over time, transferring long-haul services from Heathrow, partly to enable it to expand frequency on other long-haul Heathrow routes and partly to develop a more complete hub at Gatwick (Outcome A3).

Outcomes in the event of BA not acquiring CityFlyer

- CityFlyer, probably under new non-airline ownership, continues as a BA franchisee (Outcome B1).
- CityFlyer, under new non-airline ownership, becomes an independent short-haul competitor (Outcome B2).
- CityFlyer establishes code-sharing/franchise agreement(s) with one or more other airlines at Gatwick (Outcome B3).
- Another EU airline acquires CityFlyer (Outcome B4).
- CityFlyer is acquired by a non-airline interest, broken up and sold off in separate 'lots' (Outcome B5).

The CAA's assessment of the possible outcomes

Outcome from BA acquiring CityFlyer

8.11. BA had indicated that it would continue to operate CityFlyer as a separate independent company using Gatwick's South Terminal and with its existing board, management and employment levels. This might support the view that, were the proposed acquisition to go ahead, Outcome A1, or at least A2, would be the most likely and it was quite possible that this would be so in the short term.

8.12. However, in the medium to long term Outcome A1 would appear a less likely outcome than A2 and, in particular, A3. The current set of routes operated by CityFlyer was a function of its equipment and, presumably, of a compromise between itself and BA. The set of routes and the equipment operated by CityFlyer would develop (even under the status quo) as markets changed, as its routes became denser and as it and BA saw commercially better destinations. If CityFlyer became a fully-owned subsidiary of BA with the opportunity to optimize the whole of BA's short-haul network at Gatwick, A2 would seem a more likely outcome.

8.13. However, it was difficult to believe that BA would wish to stop there. It was likely that it would continue to put a high priority on development of the most profitable—business travel—market at Heathrow and that this would lead, *inter alia*, to its wishing to build frequency on long-haul routes with a high business content. Recent indications were that it would also begin to replace some of its B747s with smaller B777 aircraft, but with higher-frequency operations. It might be able to purchase some of the additional Heathrow slots this would require, but it was more likely that it would have to move other services to Gatwick in order to free up Heathrow slots.

8.14. Thus BA's strategy was likely to focus on optimizing its overall London network and, on the evidence of recent years, to continue to reorganize its long-haul services. The constraints at Heathrow applied to terminal capacity and aircraft stands as well as runway capacity and meant that BA could not simply switch a slot from a short-haul to a long-haul route. If it wished to increase frequency on some long-haul routes at Heathrow it might therefore need to transfer other long-haul services to Gatwick. At present it could do so only using its own slots at Gatwick whereas under Outcome A3 it could also use CityFlyer's slots, many of which were well timed for such long-haul operations.

Outcomes from BA not acquiring CityFlyer

8.15. Although CityFlyer was currently profitable, a significant proportion of its traffic consisted of feed to or from BA's services and the use of the BA brand increased its attractiveness to local passengers, especially high-yielding business passengers. A number of Gatwick-based independent short-haul airlines had failed in the past and, although the general development there and congestion at Heathrow might have improved their situation, CityFlyer's prospects as an independent were likely to be significantly worse than as a franchisee, particularly a BA franchisee. This suggested that, if CityFlyer were to cease to be a BA franchisee and instead were to operate as an independent competitor, this might push its existing profitable operation into loss. Thus Outcomes B1 and B3 seemed more likely than Outcome B2.

8.16. If CityFlyer were nevertheless to attempt to survive as an independent but then failed, its slots would revert to the pool to be reallocated by the Coordinator under the rules laid down in the EC slot regulation. The evidence was that where they were in demand such pool slots were reallocated thinly over a wide range of routes and airlines—both new entrants and incumbents, including BA and its franchisees.

8.17. The difficulty which CityFlyer would face in seeking to strike an effective franchise deal with an airline or airlines other than BA (Outcome B3) would be the relatively small scale of these other airlines. As already noted, BA operated about 40 per cent of the scheduled flights at Gatwick and the closest potential partners for CityFlyer were Alitalia (3 per cent) and long-haul carriers such as Virgin Atlantic and Continental with 2 per cent or less. American Airlines, with five arrivals and departures each day at Gatwick, also had 2 per cent of the total and was of course an airline with which BA continued to endeavour to build a global partnership.

8.18. There were other scheduled operators with a presence at Gatwick. However, three of these were either BA subsidiaries or franchisees while none of the others would provide any substantial network 'fit' with CityFlyer's operations. Even in aggregate—assuming the sort of multiple code-sharing arrangement developed by British Midland at Heathrow—feed traffic from potential partners for CityFlyer at Gatwick would be likely to be substantially lower than that currently provided by BA. The lack of a home market carrier with a major brand name would also be likely to affect adversely the volume of passenger feed and probably also the percentage of high-yielding business traffic.

8.19. So far as an outright acquisition of CityFlyer by another airline was concerned (Outcome B4), the number of potential candidates would in reality be strictly limited. Under EC legislation CityFlyer would be required to remain majority owned and effectively controlled by EU nationals or governments in order to retain its operating licence. Thus it could not be acquired by a US or other non-EU airline seeking a feeder network for its own long-haul services into Gatwick. Any shareholding by a non-EU airline would need to be a minority one and such that the airline concerned could not be said to exercise effective control. In practice Virgin Atlantic would seem to be the most likely potential airline candidate to acquire CityFlyer if BA were to be prevented from doing so. Alitalia, with only seven arrivals and departures a day, was the airline with the largest non-UK EU airline slot holding at Gatwick. But given that the respective hubs of CityFlyer and a foreign carrier such as Alitalia would be at different airports in different countries, there would be no real network fit.

8.20. For Virgin Atlantic the main benefit of acquiring CityFlyer would be that it would provide ample suitable slots for future expansion of its long-haul network. However, Virgin Atlantic's demand for slots for such expansion at Gatwick would, in the short term at least, probably account for only a relatively small proportion of slots made available by the acquisition of CityFlyer. In the absence of an overt secondary market, it would be difficult for Virgin Atlantic to sell on the potentially large number of residual slots. It was possible, however, that it would wish to retain control over at least some of such slots. This might be for longer-term strategic reasons relating to its plans for the development of its network of long-haul services at London, or perhaps even for the development of supporting short-haul feeder services. Indeed, it might wish to retain control over the remaining slots against the day when secondary trading might be explicitly recognized under EC law and their full market value could be realized.

8.21. To retain slots it would need to put them to some alternative use in the short term. This might mean a continuation of the CityFlyer operation, or something broadly akin to it, or perhaps the introduction of Gatwick services by its Brussels-based low-cost no-frills airline subsidiary Virgin Express. Neither option would be without its difficulties. High and worsening levels of congestion at Gatwick, combined with a higher level of airport charges than at secondary airports of the type normally favoured by low-cost no-frills operators, suggested that such an operation might face an even greater than usual challenge.

8.22. However, the retention in the short term of a conventional short-haul feeder network would also seem to bring its own risks. While it would presumably benefit from Virgin Atlantic's strong brand recognition in the UK, the scope for feed between long- and short-haul operations would be substantially less than that which currently existed between BA and CityFlyer. It was difficult to be sanguine therefore about the prospects for even Virgin Atlantic establishing and sustaining a successful short-haul operation at Gatwick although, given Virgin Atlantic's track record in innovation, it would also be difficult to regard either of the above options, or perhaps some hybrid of the two, as being wholly unrealistic.

8.23. One potentially attractive sub-option within Outcome B4 might be for Virgin Atlantic to transfer out of the CityFlyer operation those slots which it calculated it would require for an expanded long-haul network over the medium to long term, then reconstituting and selling the remainder as a somewhat smaller airline. On the face of it this would circumvent any legal concerns regarding the sale of slots. The price received by Virgin Atlantic would reflect the use to which the new owners were able to put the now smaller airline and this in turn would have been reflected in the original price paid by Virgin Atlantic for CityFlyer. It was always possible that the new smaller airline would become a BA franchisee, or even that BA itself might seek to acquire it, depending on how many attractive long-haul slots it retained.

8.24. As regards Outcome B5—the break-up and sale of CityFlyer in separate lots—the restrictions on nationality of ownership and control, which would limit the potential purchasers of CityFlyer as an airline, would not apply to the purchase of the airline's slots. Although BA would be likely to value CityFlyer as an entity more than any other potential purchaser, and thus be in a position to outbid them, this is not necessarily true of all of its slots. Airlines such as US Airways, seeking to compete with BA on routes from their US hub airports and which might only require one or two slot pairs a day, might well outbid BA. However, the difficulty with this option lay in the legal ambiguity concerning secondary trading in the existing EC slot regulation. Breaking CityFlyer up into separate 'airlines' might be an option, although even this might risk legal invalidation as being merely a device to circumvent the regulation.

Implications for potential competition of the merger being permitted

8.25. The CAA took the view that if BA were to be permitted to acquire CityFlyer, its strategic focus would continue to be on optimizing its overall London network. Thus Outcome A3 was regarded as the most likely one, at least for the longer term. The CAA then compared the competitive implications of Outcome A3 against the counterfactuals B1 to B5.

Outcome B1: CityFlyer, under new non-airline ownership, continues as a BA franchisee

8.26. Outcome B1 represented the status quo in all material respects and there seemed no reason to suppose it would not continue to succeed commercially. If overt secondary trading were not to be introduced in the foreseeable future and if the acquisition was prevented from going ahead, B1 seemed to be one of the most likely outcomes. Similarly, there was no reason in logic to suppose that CityFlyer's network or its future development would be affected compared with the position today. BA would presumably still continue to seek to optimize its overall London network, probably with further transfers of long-haul services from Heathrow to Gatwick, drawing progressively on the slots used by those of its own most marginally profitable short-haul.

8.27. Under Outcome A3 BA would be enabled to draw on a larger and, in terms of their timings, wider range of slots in order to continue to seek to optimize its overall London network. This would give it significantly increased flexibility in operating and marketing its long-haul services from Gatwick while at the same time other incumbent or new entrant long-haul competitors would face severe constraints in obtaining slots at the airport through the normal allocation process, as witnessed by the recent problems encountered by US Airways and Continental. However, any systemic effect on competition on short-haul routes would be unlikely given that BA would in effect be exchanging one subset of short-haul routes rather than another to provide long-haul slots.

8.28. Given that the combined BA/CityFlyer Gatwick slot holding would not be more than about 40 per cent, it could be argued that competitors requiring slots could purchase them from airlines other than BA. However, for so long as it continued, the existing uncertainty over the legality of slot trading must have the effect of seriously impeding the development of an efficient slot market. If slot trading with clearly defined property rights were to exist, many more airlines than today might be prepared to sell slots at the 'right' price. However, there was the further issue as to whether this price would be too high for prospective competitors in circumstances where BA's network strength, and perhaps a strategic motive on its part to exclude or at least impede its potentially most effective competitors, would mean that it would always be likely to value slots more highly than others.

Outcome B2: CityFlyer, under new non-airline ownership, becomes an independent short-haul competitor

8.29. Were it to be commercially viable, Outcome B2 should provide a significant improvement in competition on short-haul routes. The airline would be in a position to optimize its own short-haul network, entering new routes or discontinuing existing ones where doing so would improve its competitiveness and its profitability. However, there must be a real risk that it would fail to survive and in this event its slots would be returned to the slot pool. Experience so far with the working of slot allocation under the EC regulation was that slots returned to the pool were likely to be reallocated thinly, benefiting in particular existing long-haul operations—foreign as well as UK airlines, and probably including BA. Thus the prospect was that Outcome B2 might lead to some strengthening, albeit fragmented, of the ability of other airlines to compete with BA on long-haul routes while any increase in competition on short-haul routes would be at best small.

Outcome B3: CityFlyer establishes code-sharing/franchise agreement(s) with one or more other airlines at Gatwick

8.30. The most realistic options here appeared to be either a Virgin Atlantic franchise or British Midland-type multiple code-sharing deals. If the latter could be made to succeed it would give a range of long-haul competitors to BA a substantially enhanced choice of independent short-haul feeder connections at Gatwick. Compared with Outcome A3, the mutual feed this would provide should strengthen competition to BA on both the long- and short-haul routes concerned. However, compared with those at Heathrow, the much smaller scale of non-BA long-haul operations at Gatwick meant that there would be a significantly lower probability that such a venture would succeed commercially and that the effects on competition would in any event be less than with British Midland's Heathrow operation.

8.31. Broadly similar conclusions seemed to apply to a Virgin Atlantic franchise. Whilst it should benefit from the Virgin brand, the long-haul feed provided by Virgin Atlantic would be likely to be much less than that which BA provided.

Outcome B4: Another EU airline acquires CityFlyer

8.32. If Virgin Atlantic were to acquire CityFlyer and subsequently was able and willing to sustain what would still be a substantial short-haul operation at Gatwick (even allowing that a proportion of the existing CityFlyer slots would be transferred over time to meet the needs of Virgin Atlantic's long-haul operations) this would be likely to provide significantly more competition on both short- and

long-haul routes at Gatwick than under Outcome A3. However, the delivery of that greater competition would depend on Virgin Atlantic being able in practice to sustain the operation and it was suggested that this might be doubtful.

8.33. That said, the alternative approach above, whereby Virgin Atlantic would reconstitute and then resell a smaller 'CityFlyer' having extracted the slots needed to meet its long-haul aspirations, might be more realistic and would still preserve the benefits for stronger competition in long-haul markets. Given that many of the long-haul routes which Virgin Atlantic wished to enter remained bilaterally constrained, it should also add impetus to the liberalization process.

Outcome B5: CityFlyer is acquired by a non-airline interest, broken up and sold off in separate 'lots'

8.34. As already touched upon, one difficulty with this option lay in the legal ambiguity concerning secondary slot trading in the existing EC slot regulation. There must be considerable doubt as to whether the secondary trading rights position would be clarified in the immediate future. If, despite this doubt, secondary trading were to be sanctioned in the near term, this outcome (which might then include the sale of individual slots) would become a realistic possibility. On the face of it this would be likely to produce a significantly more pro-competitive result than Outcome A3. However, before reaching such a conclusion it would be necessary to address the issue that BA's network strength and underlying market power might mean that, if it were not excluded from bidding for CityFlyer's slots, it would normally be able and willing to pay more than other airlines. If this were to be the case, the effect on competition of this outcome might not be very different from allowing the acquisition to proceed.

Implications for users of airline services

8.35. In general the CAA regarded the outcomes which generated most competition for the local market as being the ones most likely to benefit UK passengers. Those benefits might be in the form of wider choice, greater frequency or lower fares but would only materialize in the longer term if competition was sustainable. The history of scheduled services at Gatwick suggested that at least some of the destinations and frequencies currently operated there were only possible because of the network synergies within and between the services of BA and CityFlyer. As discussed above, the services of CityFlyer might be vulnerable if divorced from the BA system. Indeed, there may be some BA routes for which the CityFlyer feed was vital. However, there might be other routes within the overall BA/CityFlyer network, particularly those serving long-haul markets, which were capable of sustaining more competition than today.

8.36. If BA's long-haul transfer strategy did not depend on its takeover of CityFlyer, then passengers with a strong preference for Heathrow were unlikely to be greatly affected whether the acquisition was permitted or not. The impact on UK users of the various outcomes discussed above would be felt by those passengers in Gatwick's core catchment area and by those who saw Gatwick as a reasonably strong substitute for Heathrow.

8.37. There would appear to be little difference in overall benefits to UK passengers in south-east England between the outcomes in which BA took over CityFlyer (A1 to A3) and the outcome in which the franchise continued (B1). There might be some network changes but not ones of great significance. The main difference was between these cases and those in which CityFlyer and BA were separated (B2 to B5). In the latter cases, to the extent they were sustainable, the probability was that the range of destinations served at Gatwick would diminish but that competition in some markets might increase. Thus there was likely to be a transfer of benefits between categories of passengers with some losing the convenience of a service from their preferred airport and others gaining in markets which had become more competitive. To the extent that Gatwick services influenced those at Heathrow, then any gains through increased competition would be more widespread. Although the evidence of such influence was at present weak it no longer appeared to be the case that leisure fares on services at Heathrow were unaffected by competition changes elsewhere. Since 1993 the development of services from alternative London airports (often low-cost carriers) had tended to induce a price response by those airlines serving the same destination from Heathrow.

8.38. The continuation of the BA/CityFlyer link was likely to bring benefits to non-UK passengers, mainly those travelling between Europe and long-haul destinations. However, the outcome for UK regional passengers was uncertain since routes such as that to Newcastle might be commercially vulnerable under any of the outcomes.

Implications for UK airlines in global network competition

8.39. Competition between major international airlines, especially those in Europe and the USA, was increasingly at the network level as well as on specific routes. BA's desire to strengthen its Heathrow hub and to develop Heathrow and Gatwick as a dual hub system was likely to be one of its main motives for the proposed acquisition. The flexibility which the acquisition would give BA in terms of slots would allow it to make greater improvements in the efficiency of its network than would be possible within its own slot holding alone. However, given the size of its slot holding on short-haul routes at Gatwick there did not seem to be a persuasive argument that it would be unable to achieve the transfers of long-haul routes from Heathrow to Gatwick which it might wish to make over the coming years.

8.40. More specifically, it might be argued that because other major EU airlines had a substantially higher proportion of overall slots at their main hubs than BA at either Heathrow or Gatwick, BA needed CityFlyer's slots in order to compete effectively at the network level. BA was in network competition with other major EU carriers such as Lufthansa, which with United Airlines was one of the two main pillars of the Star Alliance, and in some markets with US airlines. BA's Heathrow hub was much smaller than those of the US airlines but so were those of all the other European carriers. BA's Heathrow hub was smaller than that of Lufthansa at Frankfurt and the purchase of Gatwick-based CityFlyer would not alter this ranking. If the purchase of CityFlyer was relevant to the network argument, then it must be that BA considered Heathrow/Gatwick as a dual-hub system. However, if Heathrow and Gatwick were considered together BA was already on a par with Lufthansa at Frankfurt, although it might be arguable that the inefficiencies of a dual hub required BA to have more slots than if BA's London network was based at a single airport.

Conclusions

8.41. The CAA believed that in order to reach a view on whether the proposed acquisition by BA of CityFlyer was against the public interest it was necessary to compare the likely developments in the market following the acquisition with those should the acquisition be prevented.

8.42. If the acquisition were to proceed, the most likely outcome would be that BA would redeploy CityFlyer's slots over time, transferring long-haul services from Heathrow, partly to enable it to expand frequency on other long-haul Heathrow routes and partly to develop a more complete hub at Gatwick. This should allow BA to improve its competitive position, both on the long-haul routes where it would thus be able to expand and more generally at a network level.

8.43. If the acquisition were to be prevented, two outcomes seemed to be most likely. CityFlyer would continue, probably under new non-airline ownership, as a BA franchisee. In that case its slots would probably continue to be allocated to short-haul European routes and there would be no substantial change in the market position.

8.44. Alternatively Virgin Atlantic might acquire CityFlyer and use those slots which it would need over time to expand its long-haul services at Gatwick, with the remainder allocated to short-haul routes—either as a feeder airline within the Virgin group, or as an independent carrier. As with BA, this expansion should allow Virgin Atlantic to improve its competitive position on the long-haul routes and possibly at a more general network level.

8.45. In seeking to assess whether the acquisition by BA of CityFlyer acted against the public interest, the CAA had given consideration to the likely effects of these different outcomes on competition at both the route and network level. However, it had found it difficult to draw firm

conclusions. This was because it believed it would require more time and more information to fully assess the relative merits of the three outcomes.

8.46. So far as competition at route level was concerned, the CAA would generally expect that an expansion of Virgin Atlantic's long-haul operations would be more likely to increase competition than such an expansion by BA. However, the actual impact on competition would depend on the routes on which the airlines sought to expand. At this stage the CAA could do little more than speculate on the likely route choices of the airlines.

8.47. In terms of network competition the CAA agreed that expansion by BA at London would improve the airline's ability to compete with the other network carriers. However, it could not be a foregone conclusion that BA needed to acquire CityFlyer in order to be able to compete. It would be important also to explore the extent of any benefit to users arising from such a network improvement.

8.48. At this stage and in circumstances where it was possible to envisage at least two counterfactuals which seemed on the face of it to be realistic and not to produce outcomes which would be demonstrably worse than that in paragraph 8.42, the CAA had therefore not been able to identify a compelling case for allowing the proposed acquisition to proceed. However, by the same token, it had not so far been able to identify a compelling case for preventing it.

8.49. Nor had the CAA yet been able to identify a clearly focused remedy that would allow the acquisition to proceed without undue negative effects for competition and for users. One possibility might be to require BA to provide suitable slots for individual competitors' new long-haul services at the time they were actually ready to begin operating, but where they would otherwise be prevented from doing so. However, for such an approach to be workable and not lead to perverse results, it would be necessary to establish a clear framework and clear decision criteria within which it would operate. It would be important, for example, to ensure that such slots were not quickly transferred to other uses and that they would not be 'wasted' on unviable and short-lived services, perhaps resulting in their being returned to the pool and thus possibly lost to the UK industry. The practical difficulties in operating such a remedy should not be underestimated.

8.50. In sum, in the short time available and in circumstances where it was necessary to make complex trade-offs between sometimes conflicting objectives and where even individual objectives might point in different directions, the CAA had not yet been able to reach a robust recommendation.

Department of the Environment, Transport and the Regions

8.51. The DETR told us that the Government sought to promote competition between airlines by removing restrictions on market access. In the EU the UK had strongly supported the development of the single market over the last decade, and there was clear evidence of substantial passenger benefits emerging. Outside the EU the UK had taken every opportunity to liberalize its bilateral arrangements with other countries. The DETR considered that the UK's aviation credentials were demonstrated by the healthy state of the UK's airline industry. BA, as the UK's major carrier, competed effectively with the largest airlines worldwide. But, uniquely in the EU, the UK was fortunate to have substantial successful competitor airlines both in short-haul markets (British Midland) and in long-haul markets (Virgin Atlantic). The UK also had an energetic and innovative low-cost airline sector.

8.52. On the global front, major carriers were increasingly seeking to compete more effectively by entering into alliances with partner airlines, so as to reduce costs and be able to offer improved network services to passengers, such as improved connections through ticketing and luggage handling, more extensive frequent flyer programmes, and access to lounges. As part of the same process major airlines were also seeking to build up the range and frequency of the services operated from the airports at which they were major users, in other words to develop hubs. These airlines regarded hub strength as essential if they were to develop a comprehensive network of routes and services. With four main global alliances apparently emerging, effective competition between major airlines might be as much between their hub networks as head-to-head on specific routes.

8.53. BA was not strongly placed at its hub airports compared with its competitors. At Heathrow it had 37 per cent of the slots, and at Gatwick 30 per cent. At Frankfurt Lufthansa had over 60 per cent of the slots, and at Amsterdam KLM had 52 per cent. US carriers enjoyed even greater hub dominance. For example, Delta controlled 80 per cent of seats out of Atlanta and US Airways controlled 91 per cent of seats out of Charlotte. It was true that none of the hub airports referred to above was as congested as Heathrow or Gatwick, although airlines could have difficulty obtaining commercially viable slots at Amsterdam and Frankfurt. But the congestion at Heathrow and Gatwick constituted not only a barrier to entry, but also a serious constraint on UK carriers' ability to expand their activities so as to compete more effectively in world markets.

8.54. Gatwick historically had not been seen as being as attractive an airport as Heathrow and airlines had struggled to set up a viable network of scheduled services under Heathrow's shadow, despite the benefits that such a network would bring to users of the airport. More recently, and reflecting the severe constraints on expansion at Heathrow, BA had begun to develop a separate Gatwick network. Heathrow's share of BA flights had fallen from 64 per cent in 1992 to 57 per cent in 1997 while the Gatwick share of BA flights to/from the UK had risen from 13 to 23 per cent over the same period. Increasingly Gatwick was becoming an airport offering an attractive range of scheduled services with the result that scheduled movements there had grown from almost 120,000 flights in 1992 to 174,000 in 1997 while charter flights (about 50,000 flights) had not grown over this period.

8.55. It was increasingly difficult to secure slots at Gatwick using the normal processes, which were based on allocation from the slot pool after slot claims on the basis of historic precedence had been met. The European Commission was of the opinion that the EC slot regulation was not intended to sanction, and could not be regarded as sanctioning, secondary slot trading. This view was not universally shared and it was generally accepted that some covert trading had taken place.

8.56. The current existence of a franchise relationship between CityFlyer and BA made the proposed acquisition somewhat unusual in that there was no loss of actual competition on the seven overlap routes. Although CityFlyer was free to set its own fares and schedules, there was no evidence to suggest that it had done so in order to compete with BA's Heathrow services. Indeed the benefits to CityFlyer of being a franchisee of BA would make this unlikely.

8.57. The benefits for a relatively small airline of acting as a feeder airline to a network carrier had implications for CityFlyer's ability to act as a potential competitor to BA at the end of the current franchise period. The difficulties of obtaining slots at Gatwick, and the small shares of slots by airlines other than BA and CityFlyer, made it seem unlikely that in the near future a competing incumbent carrier could establish an alternative Gatwick network to rival BA's. To the extent that CityFlyer saw its financial viability as a short-haul feeder carrier, this limited its freedom to act as a potential competitor to BA on the overlap routes. Developments in the industry suggested that BA was likely to continue to see mutual benefits from such a relationship.

8.58. The effects on potential competition to CityFlyer on the overlap routes by other airlines was also likely to be unaffected by BA's acquisition. The existing strong economic relationship between CityFlyer and BA made it unlikely that competitors would have considered CityFlyer currently to be a weak competitor or perceived it to be greatly strengthened by the acquisition.

8.59. It seemed unlikely that the new low-cost carriers would see congested airports like Gatwick as a natural choice for mounting their brand of point-to-point frequent short-haul services. No such presumption could be made in respect of long-haul carriers, particularly since Virgin Atlantic had expressed strong opposition to the acquisition. However, their more limited slot requirements meant that long-haul carriers were less likely to be able to use all of CityFlyer's slots, and this would depress any bids for CityFlyer.

8.60. There were competition issues that arose from BA's acquisition of CityFlyer's slots as a consequence of acquiring the airline. Those stemmed from the flexibility available to incumbents in switching slots between routes, and from the lack of available slots for airlines wishing to expand or

gain access to a congested airport. Also, the absence of a mechanism under the existing EC slot regulation for selling off surplus slots limited the range of alternative bidders willing to acquire CityFlyer's significant portfolio of slots and the price willing to be paid for CityFlyer by airlines with limited slot ambitions.

8.61. However, for as long as secondary slot trading was not formally permitted, issues raised by the indivisibility of CityFlyer's slots would exist even if the acquisition did not go ahead. If CityFlyer remained as a BA franchise airline, BA would have an incentive to ensure that CityFlyer's slots were all used for BA services, even suboptimally, partly to avoid its competitors being able to acquire them if any should be returned to the slot pool, but also to maximize the feed effects for its network.

8.62. The very different range and scale of services operated by BA and CityFlyer made it possible that BA and CityFlyer would reach different decisions as to the use of CityFlyer's slots. The likely greater profitability of BA's long-haul services would create financial incentives for BA to use some of CityFlyer's slots for its long-haul services, but its interest in developing a Gatwick network with adequate feed traffic would tend to constrain the extent to which it would wish to do this.

8.63. Without secondary slot trading, it would only be possible, as now, for CityFlyer to dispose of its slots by returning them to the slot pool without any financial compensation. The realistic options for CityFlyer after the current franchise period were therefore to continue as a franchise airline of BA; to become independent; or to become a franchisee of another airline. The economic arguments that bound CityFlyer to BA would be highly likely to continue to apply after the franchise period ends.

8.64. If secondary trading were to be sanctioned in the near future, CityFlyer would additionally have the option of selling its slots to the highest bidder. Allowing BA's acquisition now would close off this possibility, which could result in a different allocation of CityFlyer's slots. However, the outcome from such a future sale of CityFlyer slots was unpredictable. At one end of the range of outcomes, the network benefits that BA obtained could mean that it would be willing to pay more for the slots than other airlines and the outcome would then be the same as allowing the acquisition to proceed. At the other end of the range, CityFlyer's slots would be spread thinly over many airlines weakening the network effects that benefited the airport, airlines and passengers but only marginally strengthening the ability of other airlines to compete against BA. In between these two extremes, there would be a stronger pro-competitive outcome if airlines like Virgin Atlantic were able to buy the slots they needed.

8.65. In the absence of secondary slot trading in the foreseeable future, the most likely outcome from preventing the acquisition would be for the franchise arrangements to continue after the current franchise period. CityFlyer's slots would remain unavailable to other airlines but development of BA's network and its aspirations to compete globally would be more constrained. Slots might be used less efficiently and the redeployment of existing BA slots for its long-haul services might lead to fewer net passenger benefits than if the acquisition were allowed to proceed. There might also be wider issues affecting the development of the UK airline industry if prevention of the acquisition were to constrain the return that might be made by outside investors and make it more difficult to attract venture capital into the industry.

8.66. The DETR recommended that the acquisition should be allowed to proceed. Should it nevertheless be felt that allowing the acquisition to proceed unconditionally was undesirable, it would be open for the Commission to recommend remedies that ameliorated the competition concerns without unduly affecting the wider benefits. However, directing remedies towards the competition concerns might not be easy. The problems of controlling the reallocation of surrendered slots suggested that this was not a suitable remedy. On the other hand, an undertaking by BA to continue to use CityFlyer's slots in the same way for the duration of the franchise period might be an appropriate way of limiting BA's ability to transfer these slots to long-haul services.

Jersey Transport Authority

8.67. The Jersey Transport Authority told us that generally it had no concerns regarding the proposed acquisition of CityFlyer by BA. However, the Authority would be concerned if there was any evidence that through the acquisition BA would seek to rationalize the operations to Jersey out of Heathrow and Gatwick with the result that the frequency and capacity of services out of either Heathrow or Gatwick was reduced.

8.68. The Authority hoped that the greater financial support that could be expected to be extended to the Gatwick route by BA would prove to be to the benefit of the travelling public.

States of Guernsey Transport Board

8.69. The States of Guernsey Transport Board (the Board) told us that it was concerned about the proposed acquisition of CityFlyer by BA. In March 1998, Guernsey lost its air link with Heathrow when Air UK withdrew from the route and transferred/sold its slots at Heathrow for a reputed £14.5 million to BA. As BA had no intention of operating a service to Guernsey, and given that there were no further suitable slots available, Guernsey consequently lost its air link with Heathrow.

8.70. CityFlyer currently operated a service between Guernsey and Gatwick. The Board was concerned that the takeover bid by BA might be part of an attempt to acquire slots at Gatwick, which would mean the loss of CityFlyer's Guernsey-Gatwick service. Despite assurances from CityFlyer that it did not intend to withdraw from the Gatwick route, the Board emphasized that the island could not afford to lose the service. Ideally, it would wish to see the reinstatement of the Guernsey-Heathrow route in addition to the retention of its existing Gatwick services.

8.71. The position in respect of air services to Guernsey had now been made worse following KLM uk's announcement on 13 February 1999 that it was to cease operating to Guernsey with effect from 28 March 1999. The airline currently provided services to Amsterdam, Stansted and Southampton. Once KLM uk pulled out of these routes, the only competition on the main UK-Guernsey services would be between CityFlyer and JEA which both offered a service to Gatwick. The Board feared that if BA took over CityFlyer and used its existing slots at Gatwick for its own purposes, which did not include operating a service to Guernsey, the island would become too dependent on one airline (JEA) and there would be no competition on the Gatwick and Southampton routes which were the most important routes for the island in terms of business and leisure travel.

8.72. The Board feared that should the proposed merger go ahead, another important air link with the UK would be lost and, for this reason, it urged the Commission not to sanction the proposed acquisition of CityFlyer by BA.

The Airport Isle of Man

8.73. The Airport Isle of Man told us that its evidence was submitted on behalf of the Department of Transport of the Isle of Man Government.

8.74. The matter was of considerable interest to the Isle of Man, because in late 1997 CityFlyer had notified its intention to start a scheduled air service from Gatwick to the Isle of Man, commencing in the spring of 1998. This proposal never came to fruition, and it was the belief of the Department of Transport of the Isle of Man that the nature of the relationship between BA and CityFlyer was the main reason for this. It understood that another of BA's franchise partners (British Regional Airlines) objected to CityFlyer's application to BA to fly a new route under a BA flight number as a franchisee.

8.75. It was possible that the planned Gatwick-Isle of Man service may have floundered for want of suitable slots at Gatwick. However, this did not detract from the fact that a market had been identified; an active proposal had been created; airport fees and charges had been agreed with CityFlyer in writing; and yet the nature of BA's relationship with its franchise partners had led to objections which delayed and prevented the new route operating.

8.76. The Department of Transport of the Isle of Man was concerned that BA's relationship with its franchise partners was such that it acted contrary to the consumer interest. A merger of BA and

CityFlyer would not improve the situation, nor prevent it from occurring again. In contrast, a CityFlyer that remained outwith BA's ownership would retain some capability for independent action, and might be expected to argue its case even if still within the BA franchise system.

D J MORRIS (*Chairman*)

R D D BERTRAM

A T CLOTHIER

A J PRYOR

P A BOYS (*Secretary*)

28 April 1999